

Wiley Finance Series

MARTIN J. WHITMAN
FERNANDO DIZ

MODERN SECURITY ANALYSIS

UNDERSTANDING
WALL STREET
FUNDAMENTALS

WILEY

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FUNDAMENTALS**

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Contents

Cover

Series

Title Page

Copyright

Dedication

Acknowledgments

Introduction

OUR FOCUS

CREDITWORTHINESS

THE APPRAISAL OF MANAGERMENTS

ACCESS TO CAPITAL MARKETS AND WEALTH CREATION

THE IMPORTANCE OF CONTROL

THE AVOIDANCE OF INVESTMENT RISK

MARKET EFFICIENCY?

DEBUNKING MYTHS

YOU NEED A LOT MORE THAN KNOWLEDGE OF ALGEBRA AND THE
ENGLISH LANGUAGE TO UNDERSTAND OUR APPROACH.

OTHER TOPICS WE COVER IN THE BOOK

Part One: The Foundations of Modern Business and
Security Analysis

Chapter 1: The Scope of Fundamental Finance, Investing, and the Investor Landscape

INVESTING VERSUS SPECULATING
THE OPMI DEFINED
ACTIVISTS
SUMMARY

Chapter 2: A Short Introduction to the Going Concern and Resource Conversion Views of Businesses

METHODS OF WEALTH CREATION
THE PURE GOING CONCERN VIEW
THE RESOURCE CONVERSION VIEW
SUMMARY

Chapter 3: Substantive Consolidation and Structural Subordination

SUBSTANTIVE CONSOLIDATION NOT OF PRIME IMPORTANCE
THE ACCOUNTING FOR STOCK OPTIONS CONTROVERSY IN LIGHT OF THE SUBSTANTIVE CONSOLIDATION DOCTRINE
STRUCTURAL SUBORDINATION NOT A SIGNIFICANT FACTOR
LACK OF PROGRESS IN EUROZONE CRISIS RESOLUTION: THE FAILURE TO USE SUBSTANTIVE CONSOLIDATION
SUMMARY

Chapter 4: The Substantive Characteristics of Securities

TYPES OF SECURITIES FOR ANALYTIC PURPOSES
CONTROL VERSUS NON-CONTROL SECURITIES
CONTROL AND NON-CONTROL PRICING AND ARBITRAGE
TERMS OF SECURITIES AS OPTIONS
WHAT A SECURITY IS DEPENDS ON WHERE YOU SIT
SUMMARY

Chapter 5: Primacy of the Income Account or Wealth Creation? What Are Earnings, Anyway?

WEALTH OR EARNINGS?
INFLUENCE OF REPORTED EARNINGS ON COMMON STOCK PRICES
THE LONG-TERM EARNINGS RECORD

PARSING THE INCOME ACCOUNT SUMMARY

Chapter 6: Net Asset Value: The Static and Dynamic Views

THE GRAHAM AND DODD VIEW ON NAV
THE FINANCIAL ACCOUNTING VIEW ON NAV
OUR VIEW ON NAV
THE USEFULNESS OF NAV IN SECURITY ANALYSIS
THE IMPORTANCE OF NAV DYNAMICS
NAV AS ONE MEASURE OF RESOURCES
NAV AS ONE MEASURE OF POTENTIAL LIQUIDITY
LIMITATIONS OF NAV IN SECURITY ANALYSES
LARGE PREMIUMS OVER BOOK VALUE USUALLY MEAN HIGH P/E RATIOS:
IT DEPENDS ON ROE
NET NETS REDEFINED
OPMI INVESTING IN COMPANIES WITH GROWING NAVS
SUMMARY

Chapter 7: Creditworthiness

CREDITWORTHINESS FROM THE BORROWING ENTITY POINT OF VIEW
CAPITAL STRUCTURE
CAPITAL STRUCTURE FROM THE CORPORATE PERSPECTIVE
FACTORS AFFECTING CAPITAL STRUCTURE
CONSERVATIVE CAPITAL STRUCTURES
SUMMARY

Chapter 8: What Matters Is Investment Risk

THERE IS NO GENERAL RISK—ONLY SPECIFIC RISK
THE COMPONENTS OF INVESTMENT RISK
SUCCESSFUL PEOPLE AVOID INVESTMENT RISK
METHODS TO AVOID INVESTMENT RISK
SAFE AND CHEAP INVESTING AND MINIMIZING INVESTMENT RISK
SUMMARY

Chapter 9: Shareholder Distributions from the Company Point of View

CASH DIVIDENDS OR RETAINED EARNINGS
STOCK DIVIDENDS
STOCK REPURCHASES
DISTRIBUTION OF ASSETS OTHER THAN CASH
LIQUIDATION
SUMMARY

Chapter 10: Roles of Cash Dividends in Security Analysis and Portfolio Management

THE THREE CONVENTIONAL THEORIES
CASH DIVIDENDS AS A FACTOR IN MARKET PERFORMANCE
THE PLACEBO EFFECT OF CASH DIVIDENDS
CASH DIVIDENDS AND PORTFOLIO MANAGEMENT
CASH DIVIDENDS AND LEGAL LISTS
CASH DIVIDENDS AND BAILOUTS
THE GOALS OF SECURITIES HOLDERS
SUMMARY

Chapter 11: The Appraisal of Managements and Growth: GARP versus GADCP

NEW FRAMEWORK FOR THE APPRAISAL OF MANAGEMENTS
MANAGEMENTS ATTUNED TO OPMI INTERESTS
MANAGEMENTS AS RESOURCE CONVERTERS
TRADEOFFS
GROWTH: GARP VERSUS GADCP
GROWTH AT A REASONABLE PRICE (GARP)
GROWTH AT DIRT CHEAP PRICES (GADCP)
SUMMARY

Chapter 12: The Significance (or Lack of Significance) of Market Performance

MARKET PERFORMANCE AND THE CHARACTER OF A PORTFOLIO
MARKET PERFORMANCE OF PORTFOLIOS VERSUS INDIVIDUAL SECURITIES
OUTSIDERS, INSIDERS, AND MARKET PRICE
PROFESSIONAL MONEY MANAGERS AND BEATING THE MARKET
PERSPECTIVE ON BAILOUTS AND THE SIGNIFICANCE OF MARKET PERFORMANCE

SUMMARY

Chapter 13: How Much Diversification?

PORTFOLIO DIVERSIFICATION VERSUS SECURITIES CONCENTRATION
CORPORATE DIVERSIFICATION VERSUS CONCENTRATION
SUMMARY

Chapter 14: Toward a General Theory of Market Efficiency

THE DETERMINANTS OF MARKET EFFICIENCY
EXTERNAL FORCES INFLUENCING MARKETS EXPLAINED
GREAT ECONOMISTS CAN LEARN A LOT FROM VALUE INVESTORS
MARKETS WHERE EXTERNAL DISCIPLINES SEEM TO BE LACKING
MARKET EFFICIENCY AND FAIR PRICES IN TAKEOVERS
SUMMARY

Part Two: Putting It All Together: Safe and Cheap Investing versus Conventional Approaches

Chapter 15: Safe and Cheap Investing

THE SAFE AND CHEAP APPROACH
BENEFITS OF THE SAFE AND CHEAP APPROACH FOR THE OPMI
RESTRICTIONS AND DEMANDS OF THE SAFE AND CHEAP APPROACH
SUMMARY

Chapter 16: Graham and Dodd Placed in Context

THE OPMI DEFINED
THE OPMI PERSPECTIVE OF ANALYSIS
THE GOING CONCERN AND INVESTMENT COMPANY VIEWS OF
BUSINESSES
PRIMACY OF THE INCOME ACCOUNT AND WEALTH CREATION
PRIMACY OF THE INCOME ACCOUNT, DIVIDENDS, AND CORPORATE USES
OF CASH
PRIMACY OF THE INCOME ACCOUNT AND THE APPRAISAL OF
MANAGEMENTS
PRIMACY OF THE INCOME ACCOUNT AND TOP-DOWN VERSUS BOTTOM-

UP ANALYSIS

PRIMACY OF THE INCOME ACCOUNT AND DIVERSIFICATION

PRIMACY OF THE INCOME ACCOUNT AND GROWTH STOCKS

MARKET RISK VERSUS INVESTMENT RISK AND MARGIN OF SAFETY

THE IMPORTANCE OF MARKET PERFORMANCE

USES AND LIMITATIONS OF FINANCIAL ACCOUNTING

SUBSTANTIVE CONSOLIDATION

COMPENSATION OF PROMOTERS

DO STOCK MARKET PRICES REFLECT CORPORATE VALUES?

TRADE-OFFS

MODERN CAPITAL THEORY VERSUS GRAHAM AND DODD

SUMMARY

Chapter 17: Academic Finance: Modern Capital Theory

THE MCT POINT OF VIEW

EQUILIBRIUM PRICING IS UNIVERSALLY APPLICABLE

THE OUTSIDE PASSIVE MINORITY INVESTOR IS THE ONLY RELEVANT MARKET

DIVERSIFICATION IS A NECESSARY PROTECTION AGAINST UNSYSTEMATIC RISK

SYSTEMATIC RISK EXISTS

VALUE IS DETERMINED BY FORECASTS OF DISCOUNTED CASH FLOWS

COMPANIES ARE ANALYZED BASICALLY AS GOING CONCERNS;

INVESTORS IN MARKETABLE SECURITIES ARE ANALYZED AS INVESTMENT COMPANIES

INVESTORS ARE MONOLITHIC: THEIR UNITARY GOAL IS RISK-ADJUSTED TOTAL RETURN, EARNED CONSISTENTLY

MARKET EFFICIENCY MEANS AN ABSENCE OF MARKET PARTICIPANTS WHO EARN EXCESS RETURNS CONSISTENTLY OR PERSISTENTLY

GENERAL LAWS ARE IMPORTANT

RISK IS DEFINED AS MARKET RISK

MACRO CONSIDERATIONS ARE IMPORTANT

CREDITOR CONTROL IS A NONISSUE

TRANSACTION COSTS ARE A NONISSUE

FREE MARKETS ARE BETTER THAN REGULATED MARKETS

THE OUTSIDE PASSIVE MINORITY INVESTOR MARKET IS BETTER INFORMED THAN ANY INDIVIDUAL INVESTOR

MARKETS ARE EFFICIENT OR AT LEAST TEND TOWARD AN INSTANTANEOUS EFFICIENCY

SUMMARY

Chapter 18: Broker-Dealer Research Departments and Conventional Money Managers

HOW RESEARCH DEPARTMENTS AND CONVENTIONAL MONEY MANAGERS THINK

PROBLEMS FACED BY RESEARCH DEPARTMENTS AND CONVENTIONAL MONEY MANAGERS

SUMMARY

Part Three: Real-World Considerations

Chapter 19: Uses and Limitations of Financial Accounting

THE CONVENTIONAL APPROACHES

FINANCIAL ACCOUNTING REPORTS AS OBJECTIVE BENCHMARKS

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AS DEFINING REALITY FOR CERTAIN SPECIFIC PURPOSES

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AS A ROAD MAP FOR DUE DILIGENCE AND LESS THOROUGH INVESTIGATIONS

SUMMARY

Chapter 20: Company Disclosures and Information: Following the Paper Trail in the United States

NARRATIVE DISCLOSURES IN THE UNITED STATES

THE DOCUMENTS AND HOW TO READ THEM

WHAT THE PAPER TRAIL DOES FOR THE OUTSIDE INVESTOR

WHAT THE PAPER TRAIL DOESN'T DO

HOW GOOD IS THE PAPER TRAIL?

SUMMARY

Chapter 21: Buying Securities in Bulk

METHODS FOR ACQUISITION OF COMMON STOCKS

ACQUISITION OF VOTING EQUITIES THROUGH EXCHANGES OF SECURITIES

ACQUISITION OF CONTROL WITHOUT ACQUIRING SECURITIES BY USING THE PROXY MACHINERY

SUMMARY

Part Four: Understanding Resource Conversion

Chapter 22: A Short Primer on Resource Conversion

LONG-TERM ARBITRAGE BETWEEN OPMI PRICES AND CONTROL VALUES
MORE AGGRESSIVE EMPLOYMENT OF EXISTING ASSETS
MERGER AND ACQUISITION ACTIVITY
CORPORATE CONTESTS FOR CONTROL
GOING PRIVATE AND LEVERAGED BUYOUTS
SUMMARY

Chapter 23: Restructuring Troubled Companies

THE FIVE BASIC TRUTHS OF DISTRESS INVESTING
REHABILITATION OF TROUBLED ENTITIES
SUMMARY

Chapter 24: The Role of Government in Reorganizations

BAILOUTS OR CAPITAL INFUSIONS?
TOO BIG TO FAIL IS A PHONY CONCEPT
THE GOVERNMENT AND PRIVATE SECTOR ARE IN PARTNERSHIP
WHETHER THEY LIKE IT OR NOT
WALL STREET PROFESSIONALS AND CORPORATE EXECUTIVES ARE ALL
IN THE BUSINESS OF CREATING MORAL HAZARDS
TAXPAYER BAILOUTS ARE A PHONY CONCEPT
A REVOLUTION IN CORPORATE REORGANIZATIONS AND LIQUIDATIONS
MAY HAVE OCCURRED IN 2009 WITH THE CHAPTER 11
REORGANIZATIONS OF GENERAL MOTORS, CHRYSLER, AND CIT
CORPORATION
STRICT REGULATION OF FINANCIAL INSTITUTIONS IS ABSOLUTELY
NECESSARY
SUMMARY

Part Five: Active Investors Buy and Sell Common Stocks on an Advantageous Basis

Chapter 25: The Economics of Private Equity Leveraged Buyouts

THE 2005 ACQUISITION OF HERTZ GLOBAL HOLDINGS AND SUBSEQUENT
EVENTS AS A PRIME EXAMPLE
SUPER-ATTRACTIVE ACCESS TO CAPITAL MARKETS
CASH PAYMENTS TO SPONSORS AND SPONSOR-CONTROLLED FUNDS
SPONSORS CONTROL OF HERTZ
SPONSORS ATTUNED TO THE NEEDS OF BANKERS AND THE WALL
STREET UNDERWRITING COMMUNITY
QUESTIONS ABOUT LBOS
SUMMARY

Chapter 26: The Use of Creative Finance in a Corporate Takeover

THE CASE
THE POSTSCRIPT
INVESTMENT LESSONS
THE APPRAISAL OF MANAGEMENT
SPOTTING DOABLE DEALS
SUMMARY

Chapter 27: The Use of Creative Finance to Benefit Controlling Stockholders

THE PROBLEMS FACED IN THE SCHAEFER CORPORATION DEAL
THE BACKGROUND OF THE DEAL
DISCOUNT PURCHASES OF RESTRICTED CORPORATE STOCK
CORPORATION'S ACQUISITION OF BREWING
PROBLEMS AND WEALTH CREATION POTENTIALS FOR THE PARTIES IN
INTEREST
SUMMARY

Glossary of Acronyms

About the Authors

Index

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Modern Security Analysis

*Understanding Wall Street
Fundamentals*

MARTIN J. WHITMAN
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WILEY

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*To the Deans, Faculty, Staff, Students and Alumni of
The Whitman School of Management
at
Syracuse University*

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The errors and shortcomings of this book belong to us alone, not at all to the various contributors.

Martin J. Whitman
Fernando Diz

Introduction

OUR FOCUS

This book is different from other books published about securities investing, securities trading, and academic finance as embedded in modern capital theory (MCT). It seems to us that all other books on investing and academic finance—ranging from *Principles of Corporate Finance* (McGraw-Hill, 2002) by Brealey and Myers to *Security Analysis: Principles and Technique* (America Media International, reprinted 2003) by Graham, Dodd, and Cottle (G&D), and to tracts on trading techniques—focus on forecasting and explaining short-run market prices, especially prices at which securities are traded in markets populated by outside passive minority investors (OPMIs). This book, in sharp contrast, focuses strictly on explaining and understanding commercial enterprises and the securities they issue. For us, short-run market prices in OPMI markets are so-called random walks except for the special cases of sudden-death securities such as options, warrants, certain convertibles, and risk arbitrage situations where there will be relatively determinate workouts in relatively determinate periods of time.

It seems to us that our approach became more relevant as a consequence of the 2008–2009 meltdown, whereas MCT and G&D approaches became less relevant.

In this book the emphasis is on creditworthiness rather than earnings and cash flows, the appraisals of managements not only as operators but also as investors and financiers, and understanding the motivations and practices of activists.

CREDITWORTHINESS

Throughout the book we emphasize the importance of creditworthiness. Three elements go into the determination of creditworthiness for functional purposes:

1. Amount of debt
2. Terms of debt
3. How productive are the use of proceeds from incurring the debt

Of these, we argue that the third element is the most important.

Also, there are three tests of solvency, and most entities do not have to pass all three to be deemed solvent.

1. Does the fair value of the assets exceed the claims against those assets (a balance sheet test)?
2. Does the entity have the wherewithal to meet its obligations as they come due (an income account test)?
3. Does the entity have access to the capital markets to meet cash shortfalls (a liquidity test)?

THE APPRAISAL OF MANAGERMENTS

Unlike others who view managements solely as operators of businesses, we appraise managements in their competencies as operators, investors, and financiers. Recently we have been acquiring the common stock of Lai Sun Garment, a reasonably fast-growing and reasonably well-financed company with assets (mostly real estate) in Hong Kong and Mainland China. The common stock at this writing is selling at about an 80 percent discount from net asset value (NAV) and less than two times reported earnings for the year ended July 30, 2012. The one question we have about Lai Sun Garment management is as financiers. With the common stock priced the way it is, why isn't the company either buying in its own common stock or the common stock of its 47 percent owned subsidiary, Lai Sun Development, whose common stock sells at a similar discount from NAV and a similar price-to-earnings (P/E) ratio? If a goal of the business is to grow NAV per share, at those prices it is hard to visualize a better use of surplus cash than buying in common stock rather than expanding the asset base or paying cash dividends.

In examining NAV, it is important to examine the dynamics of NAV rather than just NAV as a static concept. For almost all corporations, NAV will grow year by year almost continuously. The quality of NAV tends to be much more important than the quantity of NAV. Certain assets contained in book value reflect overhead unlikely to ever be recovered through earnings or cash flow. Those are the types of NAV common stocks we try to avoid. There are valuable lessons to be learned from G&D's analysis of net nets.

Payments to shareholders in the form of either dividends or stock buybacks has to be a residual use of cash most of the time compared with using cash to expand corporate assets or reduce corporate liabilities. However, from a corporate point of view it sometimes makes sense to pay large and increasing dividends, because that can give the corporation better access to capital markets than would otherwise be the case. Also, managements might consider large dividends simply because they are desired by so much of the company's OPMI constituency.

ACCESS TO CAPITAL MARKETS AND WEALTH CREATION

Another factor this book dwells on deeply that others seem to ignore is the importance for companies to have access to capital markets—both credit markets and equity markets. As the book points out, capital markets are notoriously capricious: sometimes not available at all (see the 2008 credit meltdown) and sometimes willing to give companies what might be characterized as “almost free money” (see the 1999 initial public offering [IPO] boom).

The goal of most corporations and most (but not all) OPMIs ought to be wealth creation, and it is important to note that there are four general ways to create wealth, not just the two seemingly cited by MCT and G&D. MCT and G&D believe in the primacy of the income account (i.e., creating wealth by flows, whether cash flows or earnings flows; earnings is defined as creating wealth while consuming cash). For us the four general ways of creating wealth—either corporate or individual—are:

1. Cash flow from operations
2. Earnings from operations
3. Resource conversion (i.e., massive asset redeployments, mergers and acquisitions, liability restructurings, changes of control, spinoffs, and liquidations)
4. Having attractive access to capital markets

It seems as if conventional security analysis puts overemphasis on four factors, which makes its approach much less useful in helping to understand a business. The four areas of overemphasis

are:

1. Primacy of the income account (to the exclusion of balance sheet and financial position considerations)
2. Short-termism
3. Emphasis on top-down analysis and a consequent denigration of bottom-up analysis
4. Equilibrium pricing (i.e., the price at any moment of time represents an efficient market, and that price will change as the market digests new information)

G&D seem guilty on the first three accounts. MCT seems guilty on all four.

THE IMPORTANCE OF CONTROL

Unlike others, control issues and changes in control are a major consideration for us. Control issues are pretty much ignored by G&D and MCT. For us, control common stocks and passively owned common stocks are the same in form, but this book dwells heavily on why control common stocks are, in fact, a vastly different commodity than non-control common stocks, certainly priced very differently in their respective markets. Control issues are also highly important in restructuring troubled companies. We suspect that subsequent to the 2008–2009 economic meltdown, an increased percentage of changes of control has occurred through recapitalization, asset sales, and capital infusions involving troubled publicly owned companies than has occurred through acquiring common stocks or using the proxy machinery to effect changes of control of healthy companies.

The book contains three tales about the use of creative finance to create highly attractive returns for various participants:

1. The 2005 LBO of Hertz Global Holdings.
2. The Leasco acquisition of Reliance Insurance—getting control without putting up cash via the judicious use of an overpriced common stock.
3. Schaefer Brewing—letting control shareholders extract large amounts of cash from a company while the control shareholders stay in control.

THE AVOIDANCE OF INVESTMENT RISK

In *Security Analysis*¹ G&D opine on the difference between investment and speculation. “An investment operation is one which upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.” We agree wholeheartedly with G&D. In this book we attempt to convince the reader that a safe and cheap approach is an investment operation, not a speculation. The avoidance of investment risk is at the center of the safe and cheap approach.

There are three general measures of investment risk:

Quality of the issuer

Terms of the issue

Price of the issue

For us, diversification is only a surrogate—and usually a darned poor surrogate—for knowledge, control, and price consciousness.

Value investing as practiced by OPMIs is one aspect of fundamental finance (FF). FF covers the following areas:

- Value investing
- Distress investing
- Control investing
- Credit analysis
- First and second stage venture capital investing

The most talented value investors seem to graduate into distress investing and control investing. Such graduates include Warren Buffett, Sam Zell, Carl Icahn, Bill Ackman, and David Einhorn.

We find that there are many, many value investors who are quite competent competitors. As far as we can tell, however, none seem to put as much emphasis on strong financial positions as we do in this book.

Safe and cheap investing is basically a buy-and-hold approach focused on the avoidance of investment risk that buys growth without having to pay for it. Security sales take place only when the security becomes grossly overpriced, when the analyst has made a mistake, when corporate conditions change, or for portfolio considerations.

MARKET EFFICIENCY?

To others, the default position embodies the MCT view that markets are efficient; to wit, the price is right. To us, in contrast, most prices are quite wrong most of the time.

The conventional thinking seems to be that one has to take huge risks to obtain huge rewards. In this book, we demur. Rather, for us the royal road to riches is not to take investment risks but rather to lay off the investment risks on someone else. Truly great fortunes have been built by those who have successfully laid off investment risk on others. These success stories include the following people:

- Corporate executives
- Hedge fund operators
- Plaintiffs' attorneys
- Bankruptcy attorneys
- Investment bankers
- Securities brokers
- Venture capitalists

We further postulate that the best—but far from the only—way for OPMIs to lay off investment risk is to acquire securities that are both safe and cheap. The elements that go into safe and cheap investing in common stocks encompass the following:

- The issuer has to enjoy a super strong financial position.
- The common stock has to be available at a minimum 20 percent discount from readily ascertainable net asset value (NAV).
- The company has to provide comprehensive disclosures, including complete audits, and also be listed or traded in markets in jurisdictions

that provide strong investor protections (the United States, Canada, and Hong Kong being examples).

- After thorough analysis, the prospects appear good that over the next three to seven years the company will be able to increase NAV by not less than 10 percent compounded annually after adding back dividends.

We do recognize certain shortcomings in our safe and cheap approach. A strong financial position, especially in the 2012 low interest rate environment, means the OPMI is dealing with managements willing to sacrifice return on equity (ROE) and return on assets (ROA) in exchange for the insurance against adversity provided by a strong financial position and the opportunism for companies that arises out of a strong financial position. Also, the OPMI market seems efficient enough so that a large discount from NAV almost always indicates an absence of catalysts that could result in immediate market appreciation. For example, in our recommended list of securities in Chapter 6, none seems likely to undergo a change of control in the foreseeable future.

DEBUNKING MYTHS

The teachings in this book reject thoroughly a number of commonly held beliefs, including the concept of “too big to fail”; the definition of corporate failure; the belief that creditworthy entities, corporate or governmental, ever repay indebtedness in the aggregate; or the belief that a capital infusion into a private enterprise by a governmental agency is, *ipso facto*, a bailout rather than an investment.

For us, these beliefs are just plain wrong:

- “Too big to fail” is meaningless. The standard has to be “too important not to be reorganized efficiently and expeditiously.” The reorganizations and/or capital infusions after 2008 into General Motors, Chrysler, CIT Group, Citigroup, and American International Group (AIG) are good examples of efficient and expeditious reorganizations of very important companies.
- We define corporate failure as a restructuring in which junior security holders are wiped out or almost wiped out. Chapter 11 reorganization does not define failure. Staying in business does not define success. After 2008, AIG and Citicorp both failed using our definitions of failure, though neither ever filed for Chapter 11 bankruptcy relief.
- In the aggregate, debt is almost never repaid by entities, which nevertheless remain creditworthy. Rather, debt is refinanced and expanded insofar as the entity—whether corporate or governmental—expands its borrowing capacity (i.e., becomes more creditworthy). Each of the companies whose common stocks are listed in Chapter 6 had greater borrowing capacity in 2012 than it had four or five years earlier. Be wary of putting debt limits on corporations or governments.

The difference between a bailout and an investment is that a bailout constitutes a capital infusion without any hope of a return, no matter how return is measured. If there are prospects of a return, as well as a return of principal, the capital infusion is an investment. The Troubled Asset Relief Program (TARP) instigated in 2008 to rescue U.S. banks was an investment by the government, not a bailout.

Great economists Keynes, Friedman, Hayek, and Modigliani and Miller probably could have learned a lot from value investors.

YOU NEED A LOT MORE THAN KNOWLEDGE OF ALGEBRA AND THE ENGLISH LANGUAGE TO UNDERSTAND OUR APPROACH.

A contrast in approaches between academic finance and us is contained in the introduction to Brealey and Myers's *Principles of Corporate Finance*, a leading finance text, where the authors state that "there are no ironclad prerequisites for reading this book except Algebra and the English language. An elementary knowledge of accounting, statistics and macroeconomics is helpful, however." To get a lot out of this book, however, the reader ought to strive to become knowledgeable in several fields—knowledgeable enough to be an informed client. Areas where knowledge is prerequisite include:

- Securities law and regulations
- Financial accounting
- Corporate law with some emphasis on Delaware law
- Income tax

Other disciplines that might come into play, depending on the particular situation being analyzed, are bankruptcy law, insurance law and regulation, banking law and regulation, and environmental law.

OTHER TOPICS WE COVER IN THE BOOK

Other views explained in depth in the book include the following:

- In FF there is no substantive consolidation but plenty of structural subordination. In particular, the company is a stand-alone entity: It is not the management, and it is not the stockholders. Every constituency in an economic entity combines communities of interest and conflicts of interest in its relationships with other constituencies.
- Essentially, stock options are a stockholder problem, not a company problem.
- It is axiomatic that if an economic entity cannot be made creditworthy, sooner or later the entity has to be reorganized or liquidated. It seems to us that no one is really doing anything on the sovereign front to make Portugal, Ireland, Italy, Greece, and Spain creditworthy. For starters, at a minimum there is a need for efficiency rather than austerity.
- For most portfolios of performing loans, time corrects the error of having bought at too high a price.
- A fair price is one that would be arrived at between willing buyers and willing sellers, each with knowledge of the relevant facts and neither under any compulsion to act. Most going-private and leveraged buyout (LBO) transactions are characterized by a coerced seller and a willing

buyer. However, OPMIs become willing sellers when offered premiums over market prices.

Instructors will find additional aids at www.wiley.com.

¹ Benjamin Graham, David L. Dodd, and Sidney Cottle. *Security Analysis: Principles and Technique*, fourth edition (New York: McGraw Hill, 1962) p. 47.

Part One

The Foundations of Modern Business and Security Analysis

CHAPTER 1

The Scope of Fundamental Finance, Investing, and the Investor Landscape

Investing versus Speculating

The OPMI Defined

Activists

Summary

Benjamin Graham and David Dodd (G&D) were prolific writers, publishing volumes in 1934, 1940, 1951 and 1962 and by Ben Graham alone in 1971. A principal problem with G&D is that almost everyone in finance talks about G&D, but very few seem to have actually read G&D.

Because so many have such a superficial understanding of G&D, their names have become synonymous with the term *value investing*. This, in turn, has led to some confusion about what it is that value investors do. Though we are influenced by G&D, our methods are basically different.

Value investing is one area of fundamental finance (FF). Value investing involves commitments in marketable securities by non-control outside passive minority investors (OPMIs).¹ A thorough discussion of how we integrate the individual components of fundamental finance investing, discussed in the first part of this book, into our safe and cheap approach to value investing is contained in Chapter 15.

The other areas of fundamental finance involve the following:

- Distress investing²
- Control investing
- Credit analysis
- First- and second-stage venture capital investing

Modern capital theory (MCT), like value investing, also focuses on investments by OPMIs. Unlike value investors, MCT focuses strictly on near-term changes in market prices and it is a top down approach rather than a bottom up approach. In a number of special cases the factors important in MCT are also important in value investing. MCT is discussed in Chapter 17.

INVESTING VERSUS SPECULATING

Since the five areas of fundamental finance involve different types of *investing* and value investing focuses on commitments in marketable securities by OPMIs, we need to be sure that the reader understands what we mean by the word *investing*.

In the first and subsequent editions of *Security Analysis*, G&D devoted an entire chapter to the problem of clearly defining the meaning of the word *investing*. Their goal was to come up with a definition that would serve as an objective benchmark that would allow people to distinguish between financial operations devoted to investing from those devoted to speculating. Although people seem to have a clear idea of what the differences between the two words are, G&D found that coming up with a precise definition of the terms ran into “perplexing” difficulties. We discuss a few of these difficulties or misconceptions that are still prevalent today later in this chapter.

The academic profession has not provided any guidance on this important matter, either. In fact, they have authoritatively contributed to the raging confusion that still exists today. For example, the prevailing view or conventional wisdom is that in order to achieve larger returns buying securities, one must undertake larger amounts of market risk. Of the many implicit mistakes in this view, one of them is the academic belief that all purchases of securities are investments. Nothing could be more misleading than this belief.

Why a Definition for Investing?

Why is it worthwhile to have precise definitions for investing and speculating? First, without a precise definition, we cannot distinguish between speculative and investment operations. On Wall Street, every speculator is called an investor. This is bad and very misleading semantics. But why should we distinguish between investing and speculating? This leads us to the second and, perhaps, more important reason. We do agree with G&D that the failure to distinguish between investment and speculative operations was in large part responsible for the wipeout or near wipeout of market participants during the 1928–1929 market crash. This failure continued to play an important role in more recent examples of wipeouts or near wipeouts of market participants (OPMIs generally) that occurred in 1974, 1987, 1989, 2000, and 2008–2009.

One of G&D’s often unrecognized and perhaps most important contribution to fundamental finance was the clear articulation of a precise definition for the concept of investing that we reproduce below:³

An investing operation is one, which upon thorough analysis that can be justified on both quantitative and qualitative grounds, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.

The difficulties encountered by G&D in coming up with a precise definition were rooted in common misconceptions about what an investment is. The above definition is helpful in the clarification of many of these misconceptions, a few of which we discuss below.

The Type of Security Does Not Define What an Investment Is

There is nothing inherent to a financial instrument that makes it either an investment or a speculation. This misconception is alive and well today.

EXAMPLE

Treasury securities are widely viewed as investment vehicles. This view notwithstanding, purchasing a 2 percent 10-year Treasury note priced at par in 2012 seems a sure loser. No credit instrument ever achieves a market price much above its call price no matter

how much interest rates go down, so it is hard to foresee meaningful capital appreciation for the Treasury note. If interest rates go up (seems a reasonable possibility from 2 percent), the market prices of the Treasury note will decline. Purchases of 2 percent 10-year Treasury notes carry a large amount of investment risk and thus can hardly be considered an investment operation. We discuss investment risk at length in Chapter 8.

Inherent to a security are only the rights that its holders have. Ownership of a security gives its owners one of two benefits:

1. Contractual rights to receive cash payments in the form of interest, return of principal, and premium. These rights in the United States cannot be taken away from holders unless the holder so consents or in a court of competent jurisdiction, usually a bankruptcy court.
2. Ownership rights, which may or may not provide for payments to owners of dividends or share repurchases that are not contractually required, except for the case of preferred stocks where cash service is required before cash is paid out to junior securities. These ownership rights can be outright or contingent as in the case of options and warrants.

Hybrid securities give their owners both benefits but at different times. Owners of convertible notes, convertible preferred stocks may have contractual rights to cash payments until they convert those rights into ownership rights.

We discuss these substantive characteristics of securities in Chapter 4.

The Method of Purchase and the Holding Time Horizon

Purchasing a common stock outright does not *ipso facto* make it an investment. Neither does buying the stock of a strongly financed company on margin make it a speculation. Similarly, the distinction between a permanent holding or temporary holding cannot be used to differentiate between investment and speculation. For example, riskless arbitrage involves the simultaneous purchase and sale of related securities, on margin, and for a short time period, but the transaction, properly executed, can be an investment operation, not a speculation. *Riskless arbitrage* is defined as a transaction that does not take any equity (or very little equity), guarantees safety of principal and a predetermined return in a fixed time period.

EXAMPLE

By September 2012 gold could be purchased in the cash market at \$1,700 per ounce. Suppose a forward contract can be written to deliver physical gold in a

year and get paid \$1,800 per ounce. The cost of financing is 5 percent per year. An arbitrage transaction will involve:

- Borrow say \$170,000 for a year at 5 percent.
- Use the proceeds of the loan to buy 100 ounces of gold in the cash market.
- Simultaneously enter into a forward agreement to deliver 100 ounces of gold in a year and get paid \$1,800/oz.
- In one year, regardless of what the price of gold in the cash and forward markets is, you will deliver 100 oz. of gold and get paid \$180,000 for it; and you will repay principal and interest on your loan of \$178,500 and pocket a riskless profit of \$1,500.

The above operation does not have any investment risk, involves purchasing gold on a fully margined basis, for a short time period, and provides more than an adequate return on no equity.

For Income or for Total Return

One common misconception is that purchases of issues for income or cash return purposes are also *ipso facto* investments. For market participants seeking satisfactory returns in mid-2012, it seems no longer possible to do so as a cash return investor. Interest rates are just too low. Rather the market participant has to focus on being a total return investor; that is, income plus capital gains. The futility of being a cash return investor is demonstrated by holding a 2 percent 10-year Treasury note priced at par. As we previously discussed, purchasing this instrument seems a sure loser. Thus, although it has become fashionable to talk about purchasing Treasury securities as a “return of capital” operation, the operation is fraught with investment risk and hardly compensates the purchaser with either an adequate cash or total return.

Investment Operation Rather than an Issue

As we have already discussed, investment character does not inhere in an issue *per se*. Price is frequently an essential element, so that a common stock or preferred stock or bond may have investment merit at one price but not at another. Along the same lines, an investment may be justified in a group of issues that could not be justified individually. Moreover, certain types of arbitrage and hedging commitments can also be considered investments. As we saw in the riskless arbitrage example, the element of safety in these types of operations is provided by the purchase/sale transaction.

Safety of Principal as the Avoidance of Investment Risk

For analytical purposes *investment* risk for a security has three components:

1. Quality of the issuer
2. Terms of the issue

3. Price of the issue

Investment must always consider the *price* as well as the *terms* of the security and the *quality* of the issuer: there is no investment issue in the *absolute* sense; that is, implying that it remains an investment regardless of price. This is important to understand because semantics often obscure this fact. The purchase of a blue chip common stock is commonly considered as an investment at any price. Not so. An investment operation focuses on the appraisal and avoidance of investment risk as shown in the following example.

EXAMPLE

It is feasible today as a total return investor to buy into blue chip common stocks, which have the following characteristics and which in our opinion probably haven't been as attractively priced as they are now since the mid-1970s:

- Super-strong financial position (quality of issuer).
- Priced at a discount from net asset value of 25 percent or more (Wheelock and Company at a discount of about 50 percent) (price of the issue).
- Full comprehensive disclosures in English with audits by the Big Four (thorough analysis, based on both qualitative and quantitative grounds).
- Trading in markets where protections for OPMIs are strong (terms of the issue).
- Prospects seem good that over the next three to eight years net asset value (NAV) will grow by not less than 10 percent compounded annually after adding back dividends. If such growth is achieved, the investments seem very likely to be profitable because if not, the discounts from NAV would have widened to unconscionable levels.

THE OPMI DEFINED

Some participants in investment operations are OPMIs; others are activists having either control or elements of control over markets or corporate decision making. OPMIs are members of the public and are distinguishable from others in three respects:

1. Individually they have no control or influence over the businesses whose securities they hold or contemplate holding.
2. They do not have access to information other than that which is generally available to the public.
3. They are those whom the U.S. securities laws and regulations have been designed to protect.⁴

Throughout the book, we refer to them as OPMIs, as well as non-control and unaffiliated security holders. The key is that they are inactive in management and not connected with the company issuing securities in any way other than as security holders. OPMIs run the gamut from day traders to most institutional investors to value investors who do not seek elements of control over the companies in which they hold securities positions. The reason for using the term OPMI rather than *investor* is that the word *investor* is one of the most misused and misunderstood words on Wall Street and is often used to describe what G&D and we would refer to as speculators.

Non-control investors are also supposed to be the beneficiaries of various state laws and

regulations, including blue sky statutes governing terms and conditions under which new issues may be offered;⁵ anti-takeover statutes; statutes aimed at controlling going-private transactions; more generalized common law and state statutory requirements covering the fiduciary obligations of those in control of corporations to unaffiliated common stockholders; and statutes defining appraisal remedies when stockholders dissent from force-out mergers or similar force-out transactions. OPMIs are additionally protected by rules promulgated by quasi-public bodies, particularly the Financial Institutions Regulatory Authority (FINRA).

ACTIVISTS

We regard as activists those participants in U.S. financial operations who have either control or elements of control or influence over businesses, who have or can obtain nonpublic information and whom federal securities regulations are intended to control rather than to protect. We believe the materials in this book are of interest to both activists and OPMIs.

SUMMARY

The concept of value investing that is often associated with Graham and Dodd is only one form of fundamental finance investing that involves making commitments in marketable securities by non-control, outside, passive minority investors or OPMIs. The other forms of fundamental finance investing are distress investing, control investing, credit analysis and first- and second-stage venture capital investing. Clearly understanding what investing is as opposed to speculation is a *sine qua non* for running fundamental finance investing operations, and the definition of investing is one of Graham and Dodd's major contributions to the field of security analysis. We clearly define the concept of the OPMI but warn the reader that the concepts covered in this book can be used and are used by all those who run fundamental finance investing operations.

¹ Since most conventional approaches to investing, e.g., Graham and Dodd (discussed in Chapter 16), modern capital theory (discussed in Chapter 17), broker-dealer research departments and conventional money managers (discussed in Chapter 18), are centered on the OPMI, we provide a more detailed description of this type of investor later in this chapter.

² The reader is referred to a book written by the authors on this area of fundamental finance: Martin J. Whitman and Fernando Diz, *Distress Investing: Principles and Technique* (Hoboken, NJ: John Wiley & Sons, 2009).

³ We thoroughly discuss the many substantive differences between our approach and Graham and Dodd's in Chapter 16 of this book.

⁴ The relevant laws and regulations are the federal securities laws administered by the Securities and Exchange Commission: the Federal Securities Act of 1933 as amended, the Securities Exchange Act of 1934 as amended, the Investment Company Act of 1940 as amended, the Investment Advisers Act of 1940 as amended, the Trust Indenture Act of 1939, and the Securities Investors Protection Act of 1970.

⁵ *Blue sky statutes* refers to state statutes governing the terms and conditions on which offerings to sell securities to the public or to buy them from the public can be made in that jurisdiction.

CHAPTER 2

A Short Introduction to the Going Concern and Resource Conversion Views of Businesses

Methods of Wealth Creation

The Pure Going Concern View

The Resource Conversion View

Summary

In this book we advocate that outside passive minority investors' (OPMIs) common stock portfolios consist of the issues of well-capitalized companies (strong financial positions), which should be acquired at prices that represent meaningful discounts from readily ascertainable net asset values (NAVs). Although this is a necessary condition for investment success (the avoidance of investment risk), it is not a sufficient condition.

The authors' most successful investments have revolved around being in bed with superior managements who were able to be opportunistic on a long-term basis, say five years or so, in taking advantage of the resources in the business. *In all cases, these resources included strong financial positions.* Obviously, the businesses benefited also from the ability of management to create, or take advantage of, other resources, including having highly efficient manufacturing abilities (Toyota Industries); having the ability to make attractive acquisitions (Brookfield Asset Management, Wheelock & Company, and Investor A/B); having the ability to employ excess capital, that is, surplus-surplus, profitably (regional and community depository institutions); having the ability to access capital markets, especially credit markets, on a super-attractive basis (Brookfield Asset Management, Forest City); and having the ability to maintain profit margins during periods of increased competition and severe economic downturn (Japanese non-life insurers).

The underlying characteristic of these superior managements, in our opinion, is that they seem to focus on the same things we focus on as buy-and-hold investors; that is, *long-term wealth creation*. Unlike most stock market participants, the primary focus of these managements is not on what periodic reported earnings per share, or periodic EBITDA (earnings before interest, taxes, depreciation, and amortization), might be.

In creating wealth, these opportunistic managements realize that there tend to be many ways to create wealth besides enjoying operating earnings. These other methods of creating wealth include:

1. Enjoying super-attractive access to capital markets, both credit markets and equity markets.
2. Being able to make opportunistic acquisitions of other companies and other assets.
3. Being able to opportunistically launch new businesses.

4. Being able to take advantage of basic mispricings in securities markets in order to, *inter alia*, repurchase outstanding common stock, spin-off glamorous subsidiaries, or liquidate assets in whole or in part.

Focusing on long-term opportunism rather than periodic earnings per share, as reported, tends to not sit well with most OPMIs. A company with a strong financial position either does not need access to capital markets or else controls the timing as to when they would access capital markets. Given this, as a general rule, the managements will tend to be nonpromotional, and at times, hardly interested at all in what Wall Street thinks.

On the opportunism issue, we are convinced that it is very difficult for most management to be opportunistic if their company's financial positions are such that the management has to be supplicants to creditors—whether those creditors be financial institutions, trade vendors, or landlords.

METHODS OF WEALTH CREATION

The above discussion highlights a view of businesses that is seldom articulated either in Graham and Dodd (G&D) or modern capital theory (MCT). How one views businesses has a profound effect on how one analyzes businesses. Throughout the book we shall make reference to the pure going concern view of businesses that is part and parcel of most conventional approaches to business and security analysis. We discuss this view below and explain why it has led to a myopic and very misleading understanding of how businesses generate wealth but nevertheless has become the conventional wisdom. More importantly, this myopic view, turned conventional wisdom, has had a profound effect on how many aspects of business and security analysis are handled; that is, from how managements are appraised, to how accounting numbers are used, to whose needs accounting rules must address, to substantively consolidating the interests of the company and its shareholders for all purposes. We contrast the conventional view with the view we hold that businesses and their dynamics are better understood as both having going concern characteristics as well as resource conversion characteristics. This latter view, which is a much more realistic representation of how U.S. and other corporations create wealth, enables us to develop a much richer framework for appraising managements as wealth creators, provides us a guide for using accounting numbers for what they mean rather than what they are, facilitates the identification of communities and conflicts of interests among business constituents, and as a result allows us and those using our approach to have much better chances at achieving long-term investment success.

THE PURE GOING CONCERN VIEW

A pure going concern is a business that creates wealth by generating flows from operations (either free cash flows or earnings) by conducting its day-to-day operations pretty much the same way it has always conducted them, managed pretty much the same way it has always been managed, financed pretty much the same way it has always been financed, and controlled pretty much in the same way it has always been controlled. Although we do not precisely know where this view originated, we can at least track it to Modigliani and Miller's 1958 paper, "The Cost of Capital, Corporation Finance and the Theory of Investment,"¹ which provides the formulation of today's concept of enterprise value (EV) as the capitalized value of after tax operating earnings. Minor adjustments to this approach have also led to the discounted cash flow (DCF) valuation method. This view on how businesses generate wealth, which is implicit in most academic finance as well as in Graham and Dodd, has led market participants to overemphasize three factors in conventional security and business analysis:

Primacy of the Income Account, that is, the primacy of flows generated

from operations as a valuation determinant—whether those flows are earnings flow or cash flows. (Earnings flows are streams of income, which create wealth for economic entities while consuming cash. In the corporate world earnings flows probably are more common than cash flows available for securities holders.)

Primacy of Short-Termism—Prediction of, and reliance on, immediate market prices and changes in those prices; these are crucial to equity pricing in securities markets dominated by OPIMs. Determining near-term outlooks for a company tends to be a much more important variable in conventional analysis than is determining underlying value.²

Primacy of Top-Down Analysis—The most important element in predicting market prices in conventional analysis are macro factors such as gross domestic product (GDP), the level of interest rates, technical market considerations, industry sectors, and the trends in stock market indices. For conventional analysis, micro factors looked at from the bottom up, such as loan covenants, appraisals of management, strength of financial positions, and access to capital markets are down-weighted compared to top-down considerations.

Moreover, under the influence of this view market participants tend to appraise managements only as operators. Managements will tend to be judged by their ability to improve margins, increase sales, organically grow the business, reduce costs, and so on. This one-dimensional view of management appraisal excludes other areas that are the purview of management including their abilities as investors (deal makers) and financiers. These activities can be orders of magnitude more important than operations in the generation of wealth, and are summarized in the saying “One good deal may create more wealth than 10 years of brilliant operations.” We discuss the appraisal of managements in Chapter 11.

Another area that has been profoundly affected by this narrow view of businesses is financial reporting; specifically how market participants and regulators view the role of Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). GAAP figures can serve two different roles for outside passive minority investors. First, an accounting number—usually earnings per share—is a tool to be used to help predict the price at which a common stock will sell in markets just ahead. Alternatively, all accounting numbers—the whole bookkeeping cycle—are tools to be used to give an investor objective benchmarks, clues to aid him or her in understanding a business and its dynamics.

The vast majority of analysts seem to view GAAP only in its first role, as a tool to be used to help predict the price at which a common stock will sell in the period just ahead. The regulators in the United States, whether governmental as embodied in the Securities and Exchange Commission, or private as embodied in the Financial Accounting Standards Board, seem to share the same view wholeheartedly. Estimating the market impact of accounting numbers is what counts for them. Thus, there is a primacy of the income account. There has to be as accurate a statement as possible of quarterly reports of income from operations; earnings before interest, taxes, depreciation, and amortization (EBITDA); and earnings per share (EPS). For those holding the view that businesses are pure going concerns, the focus is on an income account, or flow, number with full attention paid to what the numbers *are*, as reported, rather than what the numbers *mean*. We discuss these issues in Chapters 5, 6, 15, and 19.

THE RESOURCE CONVERSION VIEW

We view companies not only as having pure going concern attributes but, more importantly, as

being engaged in what we call *resource conversion* activities. These activities include mergers and acquisitions, spinoffs, buyouts, recapitalizations, liquidations, changes of control, and other activities that generate wealth by putting resources to other uses, other ownership, and other control. Rather than being strict going concerns, virtually all businesses whose equities are publicly traded combine going concern characteristics with resource conversion (investment company) characteristics. As an illustration of this point, [Table 2.1](#) shows the frequency of certain types of resource conversion activities for the companies in the Dow Jones Industrial Average Index for the five years from June 2007 through June 2012.

Table 2.1 Resource Conversion Activities of Dow Jones Industrial Companies from June 2007 to June 2012

Company Name	Number of Private Placements	Number of Mergers/ Acquisitions
3M Co.	1	27
Alcoa, Inc.	1	6
American Express Company	5	6
AT&T, Inc.	1	18
Bank of America Corporation	4	64
Caterpillar Inc.	0	13
Chevron Corporation	0	24
Cisco Systems, Inc.	14	44
E. I. du Pont de Nemours and Company	2	16
Exxon Mobil Corporation	1	36
General Electric Company	5	17
Hewlett-Packard Company	0	24
Intel Corporation	1	27
International Business Machines Corporation	2	44
Johnson & Johnson	0	10
JPMorgan Chase & Co.	7	33

Kraft Foods Inc.	0	8
McDonald's Corp.	1	6
Merck & Co. Inc.	2	16
Microsoft Corporation	5	31
Pfizer Inc.	1	30
Procter & Gamble Co.	2	22
The Boeing Company	0	10
The Coca-Cola Company	1	12
The Home Depot, Inc.	0	3
The Travelers Companies, Inc.	0	0
United Technologies Corp.	0	3
Verizon Communications Inc.	2	4
Wal-Mart Stores Inc.	3	8
Walt Disney Co.	0	9

Table was built using S&P Capital IQ.

While income accounts, that is, flow data, are integrally related to net asset value (NAV), for many companies NAV and changes in NAV are far more important determinants of value than are earnings, or cash flows, from operations. Such NAV-centered companies include Berkshire Hathaway, almost all mutual funds, most income-producing real estate entities (such as Forest City Enterprises), most control investors (such as Brookfield Asset Management), and most conglomerates (such as Cheung Kong Holdings).

When one views companies as businesses combining going concern characteristics as well as resource conversion characteristics, the focus of analysis changes considerably since wealth is generated in a multiplicity of ways. Substantive areas where the focus of analysis changes are:

1. There is no primacy of the income account in the analysis because wealth is created both through going concern activities and resource conversion activities. The weight applied to the different activities in the analysis will be case specific. There are no general rules, only case-specific rules. We thoroughly discuss this point in Chapters 5, 6, 7, and 19.

Accounting numbers are analyzed for what they mean rather than what they are with a special emphasis to the entire accounting cycle not just one number. A thorough discussion of this point is given in Chapter 19.

The quality and quantity of resources of a company become important factors of analysis. As we said at the beginning of this chapter, one example of such resource is having a strong financial position. A strong financial position offers the OPMI's insurance (minimization of investment risk) and management the ability to be opportunistic. We discuss these issues in Chapters 6 and 7.

Managements are no longer appraised only as operators but also as investors and financiers. We discuss this point at length in Chapter 11.

The focus of our approach is the avoidance of investment risk not market risk, which we discuss in Chapters 8 and 12.

There is no substantive consolidation of the interests of the company with those of the shareholders or any other corporate constituency. These issues are presented in Chapter 3.

Securities have substantive characteristics that must be understood. We discuss the substantive characteristics of securities in Chapter 4.

Portfolios of securities using our approach will tend to be concentrated rather than diversified. Diversification is a surrogate, and usually a damn poor surrogate for knowledge, control, and price consciousness. Diversification is discussed in Chapter 13.

SUMMARY

The remainder of this book is devoted to explaining and discussing all the elements of our approach. A key to understanding where these elements come from is realizing that businesses generate wealth in a multiplicity of ways, of which flows from operations (either cash flows or earnings) are only one.

¹ Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," *American Economic Review* 48, no. 3 (1958): 261–297.

² This fact had been already pointed out as early as 1936 by John Maynard Keynes in Chapter 12 of his *General Theory of Employment, Interest and Money* (CreateSpace Independent Publishing Platform, 2011).

CHAPTER 3

Substantive Consolidation and Structural Subordination*

Substantive Consolidation Not of Prime Importance

The Accounting for Stock Options Controversy in Light of the Substantive Consolidation Doctrine

Structural Subordination Not a Significant Factor

Lack of Progress in Eurozone Crisis Resolution: The Failure to Use Substantive Consolidation

Summary

In fundamental finance investing; that is, value investing, control investing, distress investing, credit analysis, and venture capital promotions, securities are examined from multiple points of view, including the company itself and control shareholders. By contrast, Graham and Dodd (G&D) and modern capital theory (MCT) look at securities analysis almost solely from the point of view of outside passive minority investors (OPMIs).¹ This difference in points of view leads to the asking of fundamentally different questions.

One key question in fundamental finance, including value investing in common stocks is:

What is a business worth long term?

The key question in G&D and MCT, however, is:

At what price will a security trade today and tomorrow in an OPMI market?

In *fundamental finance*, OPMIs and OPMI interests are merely the tip of a huge iceberg. To study financial phenomena by focusing on the day-to-day trading environment strictly from an OPMI point of view is akin in marine biology to studying the entire marine food chain by restricting the examination to the reactions of kelp and plankton floating on the ocean's surface. Kelp and plankton merely react; beneath the surface, there exist myriad actors, such as shark, tuna, cod, and whales. These beneath-the-surface actors in the marine food chain are similar to the groups in the financial community that we describe in Chapter 14 when we discuss promoters' and professionals' compensations.

MCT appears to be useful in describing a special case with two components:

1. The sole object of the market participant is to maximize a (market) risk-adjusted total return consistently (i.e., all the time) realizable in cash by sale to the OPMI market.
2. The need to examine only a relatively few variables in analyzing a security or commodity. In the securities arena, issues analyzable by reference to only a few computer-programmable variables seem restricted

to the following:

- Credit instruments without credit risk (e.g., U.S. treasuries).
- Derivative securities such as convertibles, options, and warrants. (The values for derivatives are determined by prices of other securities rather than by any analysis of the underlying values attributable to a security, such as a common stock.)
- Risk arbitrage securities where the workouts are short run (i.e., there are relatively determinant workouts within relatively determinant periods of time).

The basic problem with MCT is that it tries to make a general law out of what is really a very narrow special case. MCT teachings are not very helpful for understanding fundamental finance, where the analysis becomes relatively complicated regardless of whether the object of the analysis involves corporate control factors or buy-and-hold passive investing. Indeed, the underlying assumptions at the heart of both G&D and MCT are either downright wrong or just plain misleading for purposes of understanding fundamental finance.

In this chapter we focus on two of these implicit assumptions of G&D and MCT, which have created important obstacles to the understanding of important issues of corporate finance in general and value investing in particular:

1. For G&D and MCT, *substantive consolidation* is of prime importance.
2. In G&D and MCT analyses, everybody's interests are structurally subordinated to those of the OPMI; that is, *structural subordination* is a significant factor.

SUBSTANTIVE CONSOLIDATION NOT OF PRIME IMPORTANCE

The ideas of *substantive consolidation*, in which the interests of the company and its stockholders are combined and seen as one and the same and *structural subordination*, in which the company's *raison d'être* is to serve the best interests of its stockholders, especially its non-control OPMI stockholders, are central assumptions of both G&D and MCT. The *substantive consolidation* and *structural subordination* doctrines so important to G&D and MCT are relative rarities in the real world, though they do exist in special cases.

EXAMPLE

The 1997 annual report of Georgia-Pacific Corporation explains at length that company policy is to forgo returns on corporate investments if it is deemed that stockholders can use that cash more productively than the company itself.

In G&D and MCT, though, the underlying assumption seems to be that substantive consolidation and structural subordination are universal, not special cases. These assumptions seem based, at best, on nothing more than anecdotal evidence. In any event, these approaches to

substantive consolidation and structural subordination are not helpful concepts at all in fundamental finance.

The terms *substantive consolidation* and *structural subordination* originated in reorganizations under Chapter 11 of the U.S. Bankruptcy Code.

Substantive consolidation occurs when, for purposes of a reorganization, two separate entities are combined into one; say, for example, a solvent parent company creditors are placed in the same class as the creditor of an insolvent subsidiary as part of a reorganization plan.

Substantive consolidation seems to occur only occasionally in the real world and, contrary to the teachings of G&D and MCT, financial managers working for companies rarely make decisions on how to employ and redeploy corporate assets on the basis of the risk profile of the company's OPMI shareholders. However, this is the underlying assumption in G&D and MCT analyses.

EXAMPLE

The idea of net present value (NPV) revolves around discounting future cash flows estimated for a project at what Richard A. Brealey and Stewart C. Myers in *Principles of Corporate Finance* call “the opportunity cost of capital—that is, the expected rate of return offered by securities having the same degree of risk as the project.” To determine this expected rate of return, “you look at prices quoted in capital markets, where claims to future cash flows are traded. . . .”^a According to MCT, if the internal rate of return implied in the future cash flows from a project is greater than the opportunity cost of capital for OPMIs, the project ought to go ahead; if it is not, the project ought to be scuttled.

^aRichard A. Brealey and Stuart C. Myers. *Principles of Corporate Finance*, Fourth Edition (New York: McGraw-Hill, 1991).

To begin with, few—if any—financial managers are in a position to figure out an opportunity cost of capital for OPMIs on the basis of factors that are fundamental to the business employing the financial manager. Efficient market theorists suggest a technical chartist approach to determining an opportunity cost of capital; they do not study a business. Instead, they study the relative historical volatility of OPMI stock prices and ascertain an appropriate discount rate taking into account that volatility. This is known as the beta.

A project's attractiveness for a company and its financial managers will be determined in almost all cases by factors particular to the company and its financial managers. Substantive consolidation based on looking at OPMI market price data is unlikely to enter into corporate decision-making. Corporate investment decision-making is instead likely to revolve around the answers to the following questions:

- Does existing management have the requisite know-how and know-who for the particular investment opportunities?
- Can the investment be financed attractively? With senior debt? With mezzanine junk? With common stock?

- Might the investment give the company more attractive future access to capital markets, especially equity markets?
- Does the investment help or hinder existing management in maintaining control?
- What are transaction costs, and who pays them?
- Given limited choices, might an alternative project be more attractive?
- How bad can a reasonable worst case be for the management? The company?

Net present value is a valid, extremely useful concept insofar as it compares the cost of a project with its expected returns. It seems useless, however, when cost and returns are measured in a substantive consolidation context.

EXAMPLE

Brealey and Myers explain on pages 73 and 74 of *Principles of Corporate Finance* that the goal of the business ought to be to make the shares “as valuable as possible” and that the company attitude ought to be that “instead of accepting a project, the firm can always give the cash to shareholders and let them invest it in financial assets.”

Almost no financial manager, however, will believe that watching stock prices, as is implicit in beta, is a way of making shares as valuable as possible for long-term OPMI shareholders and control shareholders. Financial managers, too, have agendas both for themselves and their companies that prevent them from just giving the cash to shareholders.

EXAMPLE

For most companies—even forgetting about restrictions on shareholder distributions that would be contained in loan agreements or bond indentures—to just give the cash to shareholders would have a negative effect on the company’s continuing relationships with trade creditors and bank lenders.

As an aside, modern capital theorists seem to measure attractive finance solely by interest rates, deeming, say, a 6 percent margin borrowing by an OPMI stockholder as more attractive in a substantive consolidation context than a corporate issuance of 12 percent subordinated debentures. The real world is a lot more complex. Attractive finance includes many factors other than interest rates. In fact, you cannot analyze without looking at all the terms and conditions attaching to a borrowing. A 12 percent 12-year subordinated debenture with a bullet maturity may be (and probably is) much cheaper money than a margin loan bearing a current interest cost of 6 percent. The margin loan may, in effect, be a demand loan, with the possible negative cash flow consequences being draconian, when compared with the 12-year non-amortizing bullet loan.

Under MCT, the fruits of attractive investments by a company will be reflected immediately in an increase in OPMI market prices, if it is assumed that the market is efficient and the information is announced. As stated in *Corporation Finance* (McGraw-Hill College, 2002), by Stephen A. Ross, Randolph W. Westerfield, and Jeffrey E. Jaffe:

Because information is reflected in prices immediately, investors should only expect to obtain a normal rate of return. Awareness of information when it is released does an investor no good. The price adjusts before the investor has time to trade on it. (p. 363)

Although their statements seem to have validity from a minute-to-minute or day-to-day trading point of view, there is no evidence whatsoever that new information immediately affects common stock valuations from the point of view of fundamental finance investing. The academic evidence is grounded in the statistical proof that no OPMI or groups of OPMIs outperform a market consistently (i.e., all the time). From a fundamental finance point of view, this observation proves nothing outside of an immediate trading environment. No long-term fundamentalist ever tries to outperform an OPMI market consistently. Consistent outperformance is strictly the domain of short-run speculators. An underlying credo of value investing is that no one not engaged full-time in high-frequency trading, option trading, or risk arbitrage can be expected to outperform a market over the short run by conscious effort. In fundamental finance, there is no focus on being the first to know. Rather the focus is not on having superior information but on using the available information in a superior manner.

THE ACCOUNTING FOR STOCK OPTIONS CONTROVERSY IN LIGHT OF THE SUBSTANTIVE CONSOLIDATION DOCTRINE

It is much more important for the U.S. economy to have its accounting systems geared toward informing creditors in a meaningful fashion than it is to have accounting systems directed toward meeting the perceived needs of outside passive minority investors (OPMIs). First, there is a lot more credit outstanding in the economy than there is net worth. Second, creditors use accounting to help determine the creditworthiness of a company by estimating whether that company will be able to generate cash internally, both long and short term, to pay its bills, and by estimating whether that company is likely to have relatively continual access to capital markets, especially credit markets. In contrast, OPMIs tend to place overemphasis on two accounting numbers—reported earnings or cash flows from operations—in order to predict what stock market prices in the immediate future might be. Bluntly, accounting systems do not seem as if they can really be very helpful as a tool for predicting near-term equity prices in OPMI markets. As far as we can tell, near-term market prices for common stocks (where there are no near-term terminal events such as maturing options, tender offers, mergers) continue to be a random walk.

From a creditor's point of view, cash payments by a company are very different from the issuance of stock options. Cash payments can affect the creditworthiness of a business. Cash payments, therefore, are a *company and creditor* problem. With minor exceptions, the issuance of stock options has no effect whatsoever on the creditworthiness of a company. Instead, stock options result presently, or prospectively, in the dilution of existing stockholders' ownership interests. Stock options are not a company and creditor problem. They are a *stockholder* problem. This simple fact is what people subscribing to the substantive consolidation doctrine miss.

Those who think of options as an expense have it wrong, at least from the company and creditor points of view.

EXAMPLE

Warren Buffett is quoted as saying, “If options are not a form of compensation, what are they? If compensation isn’t an expense, what is it? And if expenses shouldn’t go into the calculation of earnings, where in the world should they go?”

Frankly, the Buffett statement is an overgeneralization, even though most finance academics, and among others, Alan Greenspan, seem to be wholly in concurrence. Stock options are not compensation from the points of view of the company itself, or its creditors. Stock options certainly are “compensation” when looked at strictly from the point of view of stockholders. The issuance of options results in present, or potential, dilution of common stockholders’ interests. Given that options result in dilution, they are best accounted for by reporting their dilutive effect in calculations of earnings per share (EPS) available for common stockholders, rather than as a theoretical expense of the company.

Stock options might well be accounted for using the treasury stock method, where it is assumed that the proceeds from an exercise of options would have been used to purchase the company’s common stock at the average market price, and the incremental shares would have been added to the common stock outstanding.

Assume Company XYZ has 1,000,000 common shares outstanding and has net income of \$1,000,000, or EPS of \$1. Assume further that Company XYZ has 100,000 executive stock options outstanding with a \$5 per share strike price and that the average market price for the common stock is \$20 per share. Therefore, EPS would be reduced from \$1 per share to \$0.93 per share because of the existence of in-the-money options

calculated as follows:

Event	Calculation	Shares
Shares assumed issued by company upon exercise of options	\$500,000 divided by \$5/share strike price	100,000
Shares assumed purchased by company at market price using proceeds from exercise	\$500,000 divided by \$20/share market price	25,000
Assumed increase in common stock outstanding	100,000 – 25,000	75,000
New common stock outstanding	1,000,000 + 75,000	1,075,000
EPS calculation	\$1,000,000 net income / 1,075,000 shares	\$0.93/share

Assuming stock options are to be treated as a company expense, which is now required under GAAP, what should that expense be? Under current accounting rules, the cost of options to the company equals the theoretical value of the options to the recipients. However, it is utterly ludicrous to suppose that the value of a benefit to a recipient has any necessary relationship to the cost to a company to bestow that benefit. It is as if a sales clerk who has a 40 percent off employee discount buys a \$100 sweater from her department store for \$60 and the store then states that it incurred a cost of \$100 because that is what the sweater is worth to the clerk, even though the company's actual cost for the sweater might be, say, \$35. The real cost of an executive option to the company (rather than to its stockholders) equals the expected present value that the option program will reduce the company's future access to capital markets, especially equity markets. We would not know how to measure such a cost. In fact, there should be an offset to this cost, namely the expected present value that the option program increases the retention of talent and/or motivates that talent productively. Quantifying this benefit is also difficult.

The cases where stock options become a company problem as well as a stockholder problem seem few and far between. Options are a company problem long term insofar as they either cause the company to pay out cash (or property); or if their issuance reduces access to capital markets. In general, those cases where stock options become a company problem seem to encompass the following:

1. The company is committed, or required, to pay out an ultrahigh percentage of future earnings as cash dividends to common stockholders. Such companies include real estate investment trusts (REITs) and many integrated electric utilities.
2. The potential issuance of common stock through the exercise of stock

options reduces the company's future access to capital markets to raise new funds.

3. The company is committed to having the amount of common stock outstanding relatively fixed, and therefore, acquires for cash, or property, enough outstanding common stock to cover the new issuance of common stock through the exercise of stock options.

On this last point, Fitch Ratings published an interesting article on April 20, 2004, in which it recognized that stock options were basically a stockholder problem, not a creditor problem; but then went on to state, "Because of their dilutive effect, many companies have a high propensity to repurchase shares issued upon exercise of employee stock options. In this context, from a bondholder perspective, employee options have a true cash cost and can be thought of as a form of deferred compensation, which has the effect of reducing available cash to service debt and increasing leverage."²

Fitch Ratings seems to be involved in overkill. First, most companies issuing stock options probably don't have stock repurchase programs. Second, any company making cash distributions to shareholders for any reason—whether such cash distributions are in the form of dividends or share repurchases—"has the effect of reducing available cash to service debt and increasing leverage." Indeed, from a creditor point of view, cash distributions to shareholders are helpful only insofar as they enhance the debtor's access to capital markets. Third, share repurchases are strictly voluntary and thus do not have as adverse a credit impact as do required cash payments to creditors for interest, principal, or premium. Finally, some share repurchases can be beneficial to creditors and companies if the common stock being repurchased pays an ultrahigh cash dividend.

The controversy over stock options, that is, whether options ought to be expensed using the fair value method—FASB 123; or whether options ought to be expensed using the intrinsic value method—APB 25, sheds much light on the reach of the *substantive consolidation* doctrine and the resulting bad direction for GAAP, which decided that FASB 123, in effect, reflected economic reality.

The FASB 123 versus APB 25 dispute was strictly about form over substance. Companies that used APB 25, the intrinsic value method, were required under GAAP in financial statement footnotes to disclose the far greater expense of the fair value method as contained in FASB 123. The whole dispute revolved around whether disclosure of an ephemeral "expense" ought to be made in the income account or in the footnotes to the financial statements. The question for the serious investor who is not a short-run stock market speculator is "Who cares?" except that in an overall appraisal of management by a trained analyst, information about management attitudes can be gleaned from looking at management opting either for FASB 123 or APB 25.

Aside from accounting issues, stock options, like virtually every other financial practice, are subject to abuse. And abuses will be common. Management ownership of stock options does not really align management interests with those of OPMIs. Rather, options give management a sharing of the upside while avoiding the risks of the downside. Certain option practices—for instance, repricing when the OPMI stock price falls—seem notorious. Further, the tax treatment of options for Internal Revenue Service purposes seems unfair from the taxpayers' point of view. Ostensibly, to avoid double taxation, when a management member becomes subject to ordinary income tax because of the exercise of an option, the company issuing the option receives a full tax deduction from its ordinary income equal generally to the difference between the market value of the exercised option and the executive's cost basis for the option shares. Other parts of the Internal Revenue Code sometimes recognize a need for relief from double (or triple) taxation, but frequently that relief is not 100 percent relief.

EXAMPLE

When a domestic corporation less than 80 percent owned by another corporation receives dividends from the other corporation, only 70 percent, not 100

percent, of the dividend income received is excluded from taxable income.

STRUCTURAL SUBORDINATION NOT A SIGNIFICANT FACTOR

Structural subordination occurs when a senior class of claimants or interests are made junior to a lower class of claimants or interests even though, on the strict basis of stated claims or interests' rights, the senior class would normally enjoy priority over other junior classes; say, for example, that because of findings of previous domination and control, secured bank debt is made the lowest class of claimant in a Chapter 11 reorganization plan.

Investors interested in fundamental finance reject the doctrine of structural subordination as it is used by G&D and MCT as utterly unrealistic. Each constituency—short-term stockholders, long-term stockholders, control stockholders, the company itself, management, creditors, vendors, employees, customers, financial professionals, governments, communities, and so on—has both *communities of interest* and *conflicts of interest* both within itself and in conjunction with other constituencies. Unlike MCT, which views things as if all constituents are structurally subordinated to the needs and desires of the OPMI, in fundamental finance it is recognized that no one constituency is necessarily senior to others in all contexts, and no one constituency is necessarily junior to all others. Myriad groups have relationships combining communities and conflicts; for example:

- Companies and management
- Management and control shareholders
- Management and OPMIs (the universality of “shark repellents” entrenching management in office is evidence of conflict)
- Company and OPMIs (e.g., OPMIs might want dividends or share repurchase programs even though these shareholder distributions may diminish corporate feasibility)
- Trading OPMIs and buy-and-hold OPMIs
- Creditors and company and shareholders
- Senior creditor and junior creditor and preferred stocks and landlords
- Government and company
- Labor unions and company
- Workforce and labor unions
- Community and company
- Corporate value at the expense of some stockholder constituencies (e.g., undertaking an initial public offering [IPO] at an ultrahigh price disadvantages new stockholders while giving new financial strength to the company)

Tom Copeland, Tim Koller, and Jack Murrin, in their 1996 text, *Valuation: Measuring and Managing the Value of Companies* (John Wiley & Sons, reprinted in 2010), incorrectly observe that “. . . shareholders are the only stakeholders of a corporation who simultaneously maximize everyone's claim in seeking to maximize their own” (p. 22). Creditors of companies where there is pressure to increase common stock dividends payable in cash would undoubtedly be very surprised to hear that their claims against the corporation are being maximized by paying out corporate cash to equity owners. Equally surprised would be managements and long-term buy-and-hold shareholders

who are pressured by OPMI shareholders who want the company to maximize short-run reported earnings per share, even when this entails forgoing attractive investments in projects with a long-term payoff or results in income tax bills that are larger than would otherwise be the case. The Copeland, Koller, and Murrin view, though, is commonly held in academic circles justifying belief in the benefits of structural subordination. Suppositions that such benefits exist to any material extent where OPMIs are the stockholders in question are based strictly on anecdotal evidence.

The MCT idea of agency costs also is not helpful in fundamental finance. The concept of agency costs arose as a modification of structural subordination, giving grudging recognition to the observation that a corporation bears costs of management at the expense of shareholders and that as a consequence, management interests may not be aligned completely with those of shareholders. The concept of agency costs is too deficient in scope to describe adequately the real-world norm of pervasive communities of interest combined with conflicts of interest.

Structural subordination, in and of itself, is a nonstarter in fundamental finance. Ross, Westerfield, and Jaffe incorrectly observed, in arguing that management influence may be limited *vis-à-vis* stockholders, that “shareholders determine the membership of the board of directors by voting. Thus, shareholders control the directors, who in turn select the management team” (*Corporation Finance*, p. 22). In the real world, perhaps 99 percent of the time, membership of the board of directors is actually determined by those who control the nominating process, not by stockholders voting proxies. To suppose otherwise is to elevate form completely over substance. The director-nominating process also is controlled by management in the vast majority of cases even given new rules that give stockholders owning 3 percent or more of the common stock for over three years, the right to have their director nominees listed in the company’s proxy statement.³

Insofar as markets are efficient, with *efficiency* defined as each market participant trying to do as well as reasonably possible, structural subordination would exist only in that special case in which the management was a sole practitioner who owned all the outstanding equity of the business. When separate managements and separate shareholder constituencies are introduced, especially control shareholders and non-control shareholders, structural subordination becomes impractical for fundamental finance purposes.

Fundamental finance operates within the context of trying to understand the diverse agendas of the important constituencies—those constituencies with clout. Entrenchment is normally very important for managements. Managements have succeeded generally in achieving a favorable environment for management entrenchment: State antitakeover laws that insulate managements in office have become virtually universal since the 1970s.

Dividend policy for many corporations will be driven, in great part, by the tax positions and liquidity needs of control shareholders. The price of the company’s common stock may be a matter of indifference to a corporate management from time to time and from situation to situation. At other times, the OPMI stock price may be crucially important insofar as the company itself or key stockholders want to access the capital market by selling common stock, either newly issued or held by existing shareholders, or by using common stock owned by a key stockholder as collateral for borrowing.

None of this is to deny that many—if not most—managements feel strong communities of interest with OPMIs focused on the immediate market price of the common stock. Many managements want buoyant OPMI prices simply because they would rather have their stockholder constituencies happy, even though shareholder unhappiness would carry no downside risks for management. In virtually every case, however, these communities of interest are modified by the universal existence of conflicts of interest.

LACK OF PROGRESS IN EUROZONE CRISIS RESOLUTION: THE FAILURE TO

USE SUBSTANTIVE CONSOLIDATION

We think that euro bonds issued and guaranteed by 5 of the 17 countries in the Eurozone, Greece, Italy, Ireland, Spain, and Portugal (PIIGS) are destined to become nonperforming loans sooner or later. The economists and politicians in charge seem to have no knowledge of what needs to be done to restructure debt. Put simply, if an economic entity cannot be made creditworthy, sooner or later that entity has to reorganize or liquidate. It seems as if none of the rescue actions being undertaken has any chance of making any of the PIIGs creditworthy.

Creditworthiness probably could be achieved if the Eurozone had the equivalent of Chapter 11, which then could result in restructuring euro debt under a Plan of Reorganization (POR). The POR would have two basic elements:

1. Euro bonds would be made the structural equivalent of U.S. Treasuries, i.e., each of the 17 member countries would jointly and separately guarantee the euro bonds. This is the substantive consolidation element of the plan.
2. Good euro credit would be reinstated, and poor credits would be required to sacrifice value. Thus, a POR may look as follows:

Country	Treatment in the POR	Present Value
Germany, Netherlands, Finland	Reinstated	100%
France	Impaired	90%
Ireland	Impaired	25%
Italy	Impaired	25%
Spain	Impaired	10%
Portugal	Impaired	10%
Greece	Impaired	5%

There are four approaches to reducing the present values of an impaired credit. They can be used separately or in concert:

1. Reduce principal amount.
2. Extend maturities.
3. Reduce interest rates.
4. Liberalize other covenants.

Liberalizing loan covenants probably would not work in a Eurozone POR. The first three might, provided that creditors were coerced into accepting a POR. In a Chapter 11 proceeding what usually happens is that all creditors are coerced into accepting a POR if each creditor class participating in a POR votes affirmatively for the plan. The required vote for each class is acceptance by those voting of two-thirds of the amount outstanding and one-half in number.

SUMMARY

The terms *substantive consolidation* and *structural subordination* originated in reorganizations under

Chapter 11 of the U.S. Bankruptcy Code. *Substantive consolidation* occurs when, for purposes of a reorganization, two separate entities are combined into one; say, for example, solvent parent company creditors are placed in the same class as the creditor of an insolvent subsidiary as part of a reorganization plan. *Structural subordination* occurs when a senior class of claimants or interests are made junior to a lower class of claimants or interests even though, on the strict basis of stated claims or interests' rights, the senior class would normally enjoy priority over other junior classes; say, for example, that because of findings of previous domination and control, secured bank debt is made the lowest class of claimant in a Chapter 11 reorganization plan.

Conventional approaches to both business and security analysis systematically substantively consolidate the interests of OPIMs with those of the company and structurally subordinate the interests of almost all other corporate constituents to the interests of the OPIM. These views are utterly unrealistic. We show examples where these views play a central role in obscuring the understanding of important issues including the accounting for stock options and the lack of progress in the Eurozone crisis resolution.

* This chapter contains original material and parts of the chapter are based on material contained in a section of Chapter 2 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman), and ideas contained in the 2002 2Q letter to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ The concept of the OPIM and its relevance was explained at length in Chapter 1.

² *Accounting for Stock Options: Should Bondholders Care?*, Fitch Ratings, www.fitchratings.com, New York, April 20, 2004.

³ Rule 14a-11.

CHAPTER 4

The Substantive Characteristics of Securities*

Types of Securities for Analytic Purposes

Control versus Non-Control Securities

Control and Non-Control Pricing and Arbitrage

Terms of Securities as Options

What a Security Is Depends on Where You Sit

Summary

In his 1938 book, *The Theory of Investment Value* (Harvard University Press), John Burr Williams stated that “investment value [is] the present worth of the future dividends in the case of a common stock, or of the future coupons and principal in the case of a bond” (p. 6). Williams was right on the money in describing the investment value of a performing loan, whether a bond, a trade credit, or a lease. For that definition to be functional, however, the investment value of a common stock has to contain many more elements than the present worth of future dividends. Thus, Williams’s definition ought to be restated: investment value is the present worth of future cash bailouts, whatever their source.

There are several forms of cash bailouts:

- Contractually assured payments by issuers to creditors in the forms of interest payments, principal repayments, and premiums for performing loans.
- Dividends to holders of equity securities, and repurchases of equity securities by issuers.
- Sale of securities to a market by an OPML, whether an outside passive minority investor (OPML) market or a control market (e.g., a merger and acquisition ([M&A] market).
- Other people’s money (OPM), which allows borrowing without disposing of the underlying security.
- The present value of benefits from control or elements of control that might exist because of securities ownership.
- Favorable tax attributes that might be created out of ownership of certain flow-through securities (e.g., a limited partnership interest in a tax shelter [TS]).

Since these bailouts attach to different types of securities, it is instructive to conceptually define the different types of securities for our analytic purposes.

TYPES OF SECURITIES FOR ANALYTIC PURPOSES

For analytic purposes, there are five types of securities:

1. Performing credit instruments, in which contracted-for cash payments are being made; most performing credits include loans, trade account payables, derivatives, leases, and many preferred stocks.
2. Nonperforming credit instruments, or debt suffering present—or near-term prospects for—money defaults; these tend to have equity characteristics.
3. Outside passive minority investor (OPMI) equity securities, which include many preferred stocks, common stocks, options, and warrants.
4. Control securities, which consist principally of common stocks, nonperforming credit instruments, credit instruments likely to become nonperforming credit instruments, and general-partner interests in partnerships.
5. Hybrid securities, including convertibles and units consisting of credit instruments with warrants attached; these securities are generally OPMI securities rather than control securities.

CONTROL VERSUS NON-CONTROL SECURITIES

Probably the most important thing to understand in examining the substantive characteristics of securities is that control common stock is essentially a different commodity from OPMI common stock. Even though they are exactly the same in form most of the time and OPMI common can be converted into control (or elements of control) common, and vice versa, the differences between control common and OPMI common are far more important than the similarities:

- They tend to trade in different markets at different prices.
- They tend to be analyzed differently.
- They tend to be bought and sold by different, largely unrelated constituencies.
- The different constituencies seek different returns on the investment.

Most OPMIs seem to seek to maximize total return mostly by sale to an OPMI market in the relatively short run; they seem to be influenced by daily changes in market prices. Most control buyers seek something off the top (SOTT), tax shelter (TS), the use of other people's money (OPM), entrenchment, and sale to another control market, or partial cash out in an initial public offering (IPO). Most control buyers are not heavily influenced by day-to-day price swings in OPMI markets unless they are actually attempting to buy, sell, or borrow against their securities positions.

- Corporate law—especially state law court decisions in leading corporate states, and federal bankruptcy law—is designed to entrench control groups and managements in office at the expense of OPMI rights. In small part, securities laws, as embodied in the amended Securities Act of 1933 and the amended Securities and Exchange Act of 1934, also have the effect of delivering management entrenchment at the expense of OPMI shareholders. Three such regulatory areas entrenching management are securities’ regulations governing cash tender offers, exchange offers, and proxy solicitations.
- The bulk of U.S. securities laws, especially as embodied in the various acts administered by the Securities and Exchange Commission (SEC), are designed to and do protect OPIMs. One of the areas of protection is against several forms of overreaching by control people through provision of:
 - Orderly trading markets
 - Disclosures
 - Oversight of fiduciaries and quasi-fiduciaries, including those who control public corporations.

CONTROL AND NON-CONTROL PRICING AND ARBITRAGE

Much of the substantive differences between control pricing and OPMI pricing are resolved through long-term arbitrages, which are the very essence of the tendency toward efficiency that exists in all markets, specifically between and among disparate markets. There are times when OPMI market prices are super-high compared with what businesses would be worth as private concerns. In that case, new shares are marketed publicly in IPOs and in secondary underwritings and M&A in which newly issued common shares, valued at or near OPMI market prices, are part or all of the consideration paid for an acquisition. At other times, OPMI market prices might be quite low compared with prevailing prices in control markets. Then, there is a tendency for cheap shares to be acquired for cash and debt, in M&A transactions, in hostile takeovers, and in the particular form of M&A called leveraged buyouts (LBOs), management buyouts (MBOs), or going-privates.

There are built-in limitations to this tendency toward long-term arbitrages. OPMI stock markets tend to be rather capricious, and certain sections of OPMI markets tend to be even more volatile than others. One extremely volatile section is the IPO market. The ability to sell IPOs can be vigorously proscribed at times (as was the case from 1991 to 1993, in the fall of 1998 and in 2008–2009), although as is pointed out in Chapter 14’s discussion of promoters’ and professionals’ compensations, the financial community has a vested interest in encouraging IPOs.

As for a control group’s buying up common stocks from OPIMs, there are three key factors that often ameliorate this tendency toward efficiency. First, the businesses involved have to be reasonably well financed, have access to credit markets in order to whet the interest of most financial (nonstrategic control buyers), or both. Second, the entrenchment of incumbent management is frequently a showstopper preventing any real efficiencies from arising in the market for changes in control. Outsiders seeking control from entrenched managements usually have to incur huge up-front expenses and almost always are faced with uncertainty as to whether control will be attainable. Finally, any process involving changes of control entails considerable administration (i.e., deal) expenses for attorneys, investment bankers, accountants, tax advisers, and others.

In a very meaningful sense, nonperforming loans are much like common stock even though there probably are less dramatic price differences here between OPMI markets and control markets. In the case of nonperforming loans, obtaining elements of control usually refers to getting influence over the reorganization process for a troubled company rather than to getting control of a business. Control over reorganization is key for creditors, whether the company restructures out of court or in Chapter 11 bankruptcy.

As to control of operations, the tendency seems to be that there is almost as much management entrenchment in troubled public companies as in healthy companies. Corporate governance provisions are an important part of virtually all Chapter 11 plans of reorganization. Also, in dealing with nonperforming loans, loan governance provisions become crucially important, especially for out-of-court reorganizations. The key loan governance player for bank loans tends to be the agent bank. For publicly traded bonds, the indenture trustee—almost always the corporate trust department of a large commercial bank—is important.

In terms of corporate governance, management entrenchment provisions are now well nigh universal. In general, though, it is far harder, with public companies, to remove a general partner of a limited partnership than to remove the management of a corporation. Usual management entrenchment devices, both corporate and limited partnership, include one or more of the following:

- Limited voting for OPMI common
- Staggered board
- Supermajorities
- Poison pills
- Parachutes
- Reincorporation in management-friendly states, such as Pennsylvania or Indiana
- Blank check preferred stocks
- A lack of stockholder rights to call special meetings

Outside passive minority investor market prices, whenever they exist, always deserve weight in any analysis. How much depends on the objectives of the investor and the characteristics of the investment; weight might range from as high as 100 percent to as low as 2 percent. Market price deserves 100 percent weight when an OPMI has as a solitary goal the risk-adjusted maximization of total return consistently (*consistently* means all the time). It may deserve 100 percent weight also when a money manager's job depends on stock-market performance, where the money manager/analyst knows little or nothing about the company in whose securities he or she is investing, or where the portfolio is fully financed with borrowed money. Finally, OPMI market prices probably deserve 100 percent weight or close to it in option trading and risk-arbitrage situations (i.e., such events as publicly announced mergers in which there will be relatively determinant workouts in relatively determinant periods of time). In all other instances, OPMI market prices deserve considerably less than 100 percent weight.

Most of the 100 percent situations involve trading by short-run-oriented speculators. When other conditions are introduced—for example, the investor, operating without borrowed funds, emphasizes contractually assured cash income rather than total return as an investment objective; the investor focuses on long-term buy-and-hold; or the analysis of a security involves great complexity (e.g., most common stocks)—weight to OPMI market prices in the analytic mix has to be reduced.

OPMI market prices are often a lot less important in the analysis of most performing loans than of non-arbitrage common stocks because:

1. Holders of performing loans need look only to service on their loans for cash bailouts. Most common stockholders would instead look for a cash bailout by sale to a market.
2. Performing loans are usually analyzed by reference to far fewer variables (e.g., current yield, yield-to-maturity, duration, collateral, and covenants) than are common stocks. Outside passive minority investor

pricing for performing loans is most often much more realistic (i.e., close to corporate values) than is the case for common stocks. Thus, with performing loans, there is usually little arbitrage between OPMI prices and control prices.

3. Time corrects many errors in holding performing loans. Such never has to happen for common stocks. Say a holder buys a 10-year 6 percent bond with a 10 percent yield-to-maturity. Assume the bond continues to sell at a 10 percent yield-to-maturity. The dollar price at the end of each year would be as shown in the following table:

Years to Maturity	Price (%)
10	75.42
9	76.90
8	78.66
7	80.53
6	82.58
5	84.84
4	87.32
3	93.06
2	96.36
1	100.00

For spread lenders OPMI market prices probably deserve considerable weight, though probably not as great as the spread between interest received and interest paid. Recent changes in Generally Accepted Accounting Principles (GAAP) requiring portfolios to be marked to market, however, elevate the importance of OPMI market prices because accounting data, as reported and unadjusted, become important for regulatory or credit rating purposes. For those who carry performing loans on margin, OPMI market prices may deserve close to 100 percent weight.

TERMS OF SECURITIES AS OPTIONS

Loans made at interest rates greater than the risk-free rate of money are substantively equivalent to credit insurance and put options. The extra interest rate is equal to insurance premiums paid to the lender for taking credit risks. The extra interest can also be viewed as having the lender sell a put option. The lender collects a premium for the right to put to the borrower, or require the borrower to buy, certain assets in certain events.

EXAMPLE

In January 1996, Third Avenue Value Fund entered into a put agreement with Heller Financial for one year. The fund sold Heller the put for a 7 percent fee. The terms of the arrangement were that in the event

Kmart filed for Chapter 11 relief in the next 12 months, Heller had the right to require the fund buy 100 percent of the principal amount of Kmart payables owned by Heller for 87 percent. This transaction actually went forward as a loan. The fund acquired from Heller for 80 percent cash a one-year medium-term note bearing interest at Libor plus 10 basis points (bips). If Kmart filed for Chapter 11 within the year, Heller could satisfy the note at its option by delivering to the fund either 87 percent cash or 100 percent in Kmart payables. If Kmart did not file, the note would be satisfied by payment of 87 percent cash to the fund.

Yield-to-maturity is an artificial calculation except for zero-coupon bonds, in that it assumes cash received over the life of the loan will always be reinvested at the original rates of return. Yield-to-maturity is an essential tool, however, for comparative analysis, comparing the theoretical returns available between and among different credit issues. It is the annual return to be earned on a performing loan over its life. The yield has two components where a loan is priced at some price other than the payment to be made at maturity. The first component is the interest rate. The second component is either the amortization of discount if the bond was acquired at a discount from the amount to be paid at maturity or the amortization of premium if the price is in excess of the principal amount to be paid at maturity.

Any term of a security ought to be viewed as an option, or privilege, granted to an issuer or as an obligation imposed on an issuer or a holder. Here is a breakdown of the status of various securities terms:

- **Call feature:** An option to the issuer.
- **Mandatory redemption:** An obligation of the issuer.
- **Cash dividend:** Once it is declared, the recipient is obligated to receive it. Before declared, an option of the issuer.
- **Stock buyback:** Any individual shareholder has the option of selling or not selling. The company has the option of putting a share repurchase program in place.
- **Cash tender offer or exchange offer:** Individual security holder has the option to accept or not accept it.
- **Merger or use of proxy machinery:** If the requisite vote is obtained, it is subject only to perfecting dissenter rights (which is hard to do); every security holder is obligated to participate.
- **Change of terms of a loan agreement regarding cash payments outside Chapter 11:** Each individual debt holder has the option of going along.
- **Change of any other term of a loan agreement outside of Chapter 11:** If the requisite vote is obtained, all debt holders have to go along.

WHAT A SECURITY IS DEPENDS ON WHERE YOU SIT

In reality, there are few rigid definitions of a security's classification; *what a security is depends on where you sit*. Subordinated debentures are a good example of a security that ought to have more than one definition. From the vantage point of the common stock, subordinated debentures are debt. From the vantage point of senior lenders, however, to whom the subordinates are expressly junior (that is what *subordination* means), the subordinates are part of the borrowing base, akin to equity. Another example would be preferred stock issued by a subsidiary where the parent company's sole asset is the common stock of the subsidiary. The parent company's principal source of cash would be dividends paid on the subsidiary's common stock. Payment of the subsidiary's common stock dividends requires prior dividend payments to the subsidiary preferred stock. The proceeds of payments on subsidiary common stock are used to service parent-company bank loans. Thus, absent any other covenants (such as the subsidiary's assets' being pledged to parent-company banks), the preferred stock of the subsidiary has a senior position *vis-à-vis* bank borrowings by the parent. In the consolidated financial statements of the company prepared in accordance with GAAP, however, the subsidiary's preferred stock appears to be junior to the parent company's bank debt.

EXAMPLE

Back in 1990, Ambase's principal subsidiary was the Home Insurance Company. Ambase owned 100 percent of the outstanding common stock of Home Insurance Company, and it was dividends on Home Insurance common stock that gave Ambase most of its wherewithal to service Ambase bank debt. Home Insurance Company 14¼ percent preferred was, in all meaningful respects, senior to the borrowings from banks by parent company Ambase.

In certain academic circles, it has been argued that little justification exists for issuing preferred stocks rather than subordinated debentures. The reasoning is that interest payable by the corporation on subordinated debentures is tax deductible, but dividend payments on the preferred stock are not tax deductible. In the real world, there are myriad reasons justifying the issuance of and the existence of preferred stocks; here are a few:

- Qualified domestic corporations that receive dividends from less-than-80 percent-owned domestic corporations can exclude from income 70 percent of such dividends received under Section 243 of the Internal Revenue Code. As a practical matter, the combined tax bills of the two corporations may be smaller when the security issued is a preferred stock rather than a subordinated debenture.
- Many—if not most—corporations have layer-cake capitalizations, and the issuance of preferred stock enables such corporations to issue considerably more senior debt than would otherwise be the case. For example, a typical finance company holding consumer receivables might

have the capitalization, shown from the bottom up here:

Variable	Value (000,000)
Common and surplus	\$100
Preferred stock	10
Junior borrowing base	110
Subordinated borrowings (equal to 100 percent of junior borrowing base)	110
Senior borrowing base	220
Senior debt (equal to three to six times senior borrowing base, of which about 66 percent would be short-term borrowings)	660-1,320
Total capitalization	880-1,540

- Assume the company can incur senior debt of four times its borrowing base. Without preferred stock being issued, such senior debt would amount to \$800 million. With preferred stock outstanding, the senior debt issuable would amount to \$880 million. In other words, the issuance of \$10 million of preferred stock would allow the company to increase its senior borrowing by \$80 million.
- Voting preferred stocks are an essential tool for tax-free exchanges in connection with mergers that qualify as reorganizations under Section 368(b) and (c) of the Internal Revenue Code. By use of preferred stocks and common stocks, it becomes feasible to satisfy the various needs and desires of disparate parties to the merger transaction:
 - Those who desire to maximize long-term total return and control would receive common stock and/or super-voting-rights common stock.
 - Those who desire cash income, relative seniority, or both, as well as something of an equity kicker, would receive convertible preferred stock.
 - There frequently are regulatory and rating agency reasons for issuing preferreds rather than subordinates.

Preferred rights are spelled out in certificates of designation, which are part of a corporation's articles of incorporation. Privately negotiated terms of preferred stocks can have quite meaningful protections for holders; whereas protections for publicly traded preferreds tend to be sparse. The most meaningful protection for publicly issued preferred stock seems to be one requiring a two-thirds vote of the outstanding preferred class if the company is to issue a new preferred stock equal or senior to the existing issue as to dividends or liquidation. The right usually given to the preferred to elect two directors if six quarterly dividends are missed is normally not much of a right at all, since the typical preferred holder has no special access to the corporate proxy machinery or to the corporate treasury to finance a proxy solicitation. An important right for preferred stocks that usually does not exist is the right to vote separately as a class on all matters.

In the case of troubled companies, preferred stocks frequently are in better positions, *de facto*, than subordinates. Subordinates have rights to accelerate if an event of default occurs and is continuing. Given the subordinates' junior position in the capitalization, this right is often the right to commit suicide. The preferred, on the other hand, piles up dividend arrearages and might be in a better position to make reorganization deals.

In pricing convertible and other hybrid securities, there are a few simple computer-programmable variables resulting in a normal convertible curve:

- Yield
- Yield-to-maturity

- Percent premium over conversion parity
- Percent premium (discount) from call
- Beta of the underlying common stock

In a market tending toward instantaneous efficiency for new issues, convertibles might be offered at prices equal to 150 to 250 basis points below comparable credits in terms of yield-to-maturity and at 25 percent to 45 percent premiums over conversion parity compared with the prices at which the underlying common stock trades.

There are trade-offs in comparing straight debt characteristics with convertibles. A shorter maturity and strong mandatory redemption requirements tend to be more valuable for a holder of straight debt, provided the debt does not trade at a premium over call price. Early maturity, early redemption, or the presence of both qualities diminishes the value of conversion privileges. For any convertible or option, long life tends to be a highly favorable characteristic. Any convertible feature is translatable into an option feature.

Alienability refers to factors that cause a security to have a fair value different from an OPMI market price. In general, there are four alienability factors:

1. Contractual restrictions on the sale of securities to an OPMI market, or any other market.
2. Securities laws restrictions on sale to an OPMI market.
3. Blockage—the amount of shares held is inordinately large compared with trading volumes in the OPMI market. Restrictions on resale and blockage are mutually exclusive, since both cannot be operative at the same time. If there are contractual or securities laws restrictions preventing sale in an OPMI market, the existence of blockage becomes irrelevant while those restrictions are in place. In a valuation, the existence of restrictions or blockage results in discounts from OPMI market prices.
4. Control—if a common stock is control common stock, it frequently results in valuations reflecting a premium above OPMI market prices.

Alienability discounts for restriction and blockage can run from 15 to 50 percent of OPMI market prices. It is hard to put a percentage number on control premiums, however; they will vary case by case.

Securities Act restrictions on resale can exist for securities not registered under the Securities Act of 1933. The restraint against public resale can be engendered by one of two conditions: the holder is an insider or the securities were never registered. Sales can be made in OPMI markets, however, pursuant to Rule 144 or a Section 4(a) exemption.

Securities Act restrictions on resale have become considerably less onerous over the years as Rule 144 has been liberalized. Presently, restricted shares held fully paid for at least six months can be resold to the OPMI market without restriction other than the public information requirement. After one year, unlimited sales into OPMI markets are allowed without any restriction. A holder of restricted stock may obtain rights of registration of the piggyback, the trigger variety, or both.

Many insiders have incentives to have low OPMI market prices and thus have inherent conflicts of interest with short-run OPMI speculators. Such incentives include:

- Estate valuation purposes: The lower the OPMI market price, the less the value of the estate either at the date of death or six months thereafter.
- Going private: The lower the OPMI price, the less insiders will have to pay in a going-private transaction.

Control insiders have basic advantages over OPMIs in that the insiders control the timing of events. For example, those control people who seek to go private can wait for a bear market in OPMI prices. The fairness of going-private transactions will always be measured in part by

premiums paid over current OPMI market prices.

The concept of dilution is never absolute. It is always relative to something: (1) OPMI price, (2) underlying values, or (3) percentage of capitalization owned.

In examining securities from the point of view of corporate feasibility, the central necessity is to be aware that a security issued by a company has to deliver one of two things to a holder: either the right to receive from the company cash payments sooner or later, or ownership interest in the company, present or potential.

The rights to receive cash payments from the company that attach to debt instruments and preferred stocks can constitute a cash drain on a business and thus detract from creditworthiness. Ownership interests—common stocks, warrants, and options—do not require cash service from the company, although such securities might not have much value to a holder unless they held promise of a cash bailout by prospects of sale to a market or of delivering control benefits to the holder.

Issuing ownership securities that do not require cash service (i.e., dividends) can detract from corporate creditworthiness insofar as the existence of non-dividend-paying equities detracts from a company's ability to access capital markets to sell new issues of equity. In the past, this has been a factor causing electric utilities and many finance companies to follow policies of paying out 60 to 80 percent of net income as dividends. For the vast majority of companies, though, dividend policy seems to have little or no impact on their ability to obtain access to capital markets. Indeed, for high-tech companies perceived as growth vehicles, the payment of regular dividends may be looked at as a negative factor, detracting from growth, in OPMI markets.

The fact that any security has to deliver either cash pay or ownership can become quite important in the structuring of appropriate capitalizations in resource conversion contexts, as in both LBOs and the reorganization of troubled companies. The appropriate capitalization ought to be feasible—not too heavy on cash-payment instruments. Also, appropriate instruments have to be issued to participants in the capitalization. Banks and life insurance companies will desire cash-payment instruments with seniority and strong covenants. Control buyers could want ownership instruments because those instruments deliver elements of control, especially when these participants do not need cash-payment instruments to service the debt they may have incurred in their own entities. OPMIs and other non-control investors could want ownership instruments because those instruments have promise of delivering a cash bailout by sale to a market.

SUMMARY

The investment value of a marketable security is the present worth of its cash bailouts whatever their source. We show many sources of cash bailouts that are outside of the radar screen of conventional approaches to security analysis. We also show that control common stocks, while identical in form to OPMI common stock, are a totally different commodity, and the pricing between these two otherwise identical securities is resolved in long-term arbitrages. For analytical purposes we classify securities into five broad groups: performing credit instruments, non-performing credit instruments, control securities, OPMI securities, and hybrids. Although our classification is useful for analytical purposes, what a security really is depends on where you sit.

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CHAPTER 5

Primacy of the Income Account or Wealth Creation? What Are Earnings, Anyway?*

Wealth or Earnings?

Influence of Reported Earnings on Common Stock Prices

The Long-Term Earnings Record

Parsing the Income Account

Summary

We define earnings from operations by any economic entity—whether corporate, governmental, or individual—as the creation of wealth while consuming cash. This seems to be how most successful economic entities operate. Earnings cannot create lasting values for an economic entity unless that entity, sooner or later, has access to capital markets to meet cash shortfalls. No economic entity can rely on having access to capital markets, whether credit markets or equity markets, unless that economic entity is, or can be made to be, creditworthy. Capital markets are notoriously capricious; there are even times when no capital is available from the private sector at any price. See, for example, the economic meltdown in the last half of 2008 and the first half of 2009.

We define cash flows from operations for most corporate analytic purposes as cash generated from operations available to service debt and equity after deducting the necessary expenditures not expensed in the income account to increase plant and equipment, receivables, inventories, non-expensed research and development as well as other assets. The modus operandi of many companies is to develop cash flows from operations; for example most companies involved with income producing real estate. The idea of cash flows from operations is crucial to understanding project finance. For a particular project to make sense, the forecasted present value in cash to be derived from operations has to exceed the present values of the cash costs to be incurred for the project. The need for cash flows from operations is less important in corporate finance because many cash-consuming activities work directly to increase wealth. These other activities include expanding operations and being involved in resource conversion activities such as mergers and acquisitions as well as refinancing maturing obligations.

Earnings and cash flow from operations tend to be important, but not all-important, in a world dedicated to wealth creation.

Wealth creation comes from three sources:

- 1. Earnings and/or cash from operations available to security holders.** Earnings are defined as creating wealth while consuming cash. This is what most well run corporations do and also what most governments do. Earnings cannot have a lasting value unless the entity remains creditworthy. Also, in most cases, in order to maintain and grow earnings the corporation or government is going to have to have access to

capital markets to meet cash shortfalls. Corporations probably create cash flows available to security holders fewer times than most people think.

2. Resource conversions. These areas include massive asset redeployments, massive liability redeployments, and changes in control. Resource conversions occur as part of mergers and acquisitions, contests for control, the bulk sale or purchase of assets or businesses, Chapter 11 reorganizations, out of court reorganizations, spin-offs, and going privates including leveraged buyouts (LBOs) and management buy-outs (MBOs).

3. Super-attractive access to capital markets. On the equity side, this includes initial public offerings (IPOs) during periods such as the dotcom bubble. On the credit side, this includes the availability of long-term, fixed-rate, non-recourse financing for income-producing commercial real estate.

Income accounts are important in any fundamental analysis of companies and the securities they issue. However, except in very special cases, there is no *primacy of earnings* or *primacy of cash flows*: that is myth, pure and simple. The one special case where there clearly is a primacy of *current earnings and earnings estimates for the immediate future* is in the trading of common stocks.

In this chapter, we examine the reasons why, outside the limited sphere of day-to-day stock trading, there tends to be no primacy of earnings in business and security analysis. We also review appropriate roles for current reported earnings within the trading environment. In this chapter, too, earnings are parsed in order to gain insights into what earnings and income mean and do not mean, and how earnings ought to be used as one tool in corporate and security analysis.

WEALTH OR EARNINGS?

In the United States, as in all societies that are beyond the survival level, the goal of most businesses is the creation of wealth rather than the generation of reported net income. Of course, the generation of reported net income and the creation of wealth are related: *the creation of reported net income is just one method of creating wealth*. There are many other ways of creating wealth that are separate and distinct from the generation of net income from operations, which we group under *resource conversion* activities and *financing* activities.¹

Where businesspeople not involved with outside passive minority investor (OPMI) stock markets have choices, the generation of reported earnings from operations tends to be the least desirable method for creating wealth, simply because reported earnings from operations are less tax sheltered than are other methods of wealth creation. This is one of the reasons why resource conversion activities and financing activities by corporations seem to have grown in importance at the expense of ordinary going concern operations.

It ought to be noted in passing that those market participants most ready to analyze corporations based on a primacy of earnings concept tend to be the same persons who in the management of portfolios renounce primacy of earnings in favor of stock market performance and total return; the creation of reported net income in the form of dividends and interest net of ordinary expenses tends to be secondary to achieving unrealized and realized appreciation.

It is well known that *privately held* corporations, even those that are strict going concern operations, usually attempt to create earnings in a manner that minimizes income taxes—an important consideration to these business people in realizing wealth creation goals.

Publicly held corporations, on the other hand, frequently attempt to report the best earnings possible, the income tax consequences be damned. This is not because business people think that current earnings per se are so all important, but, rather, because the ability to report favorable

current earnings may have the most favorable impact on stock prices and access to capital markets, which in turn may provide the greatest potential for wealth creation. High common stock prices provide insiders with opportunities to realize values by selling or borrowing. They also give a company opportunities to issue new equity in public underwritings for cash, or to acquire other companies either for cash or by the direct issuance of common stock or other equity securities.

Frequently, the best tool for projecting future earnings is the structure and amount of asset value at a given moment.

EXAMPLE

Society Corporation's position in the early 1960s is one example of this. Society Corporation was a bank holding company based in Cleveland, Ohio. At that time, banks in general were earning between 8 and 12 percent of net worth annually. Society, with a net worth of about \$50 a share, was earning about \$1.50 a share from operations when it converted from a mutual savings bank to a commercial bank holding company in 1962. This equaled a return on net worth of only 3 percent. A market participant could reason with a fair degree of confidence that over time Society probably would be earning a return on its equity close to that which was being achieved in the commercial banking industry in general. At least, there did not appear to be any insurmountable problems preventing this. Furthermore, book value, too, would be steadily increasing. The anticipated results occurred; reported earnings increased year by year, and by 1966 operating earnings were \$5 per share on a year-end book value of \$62. The prediction of Society Corporation's future earnings could not have been based on the past earnings record. An examination of the asset values and the belief that such asset values would be used much the way other commercial bank holding companies used theirs were the basis for the earnings forecast. This approach is probably better described as a *resource conversion* approach to analysis rather than a strict *going concern* one. Why? The key item in evaluating Society Corporation was the probability that it would convert its assets to more

productive uses, not that it would continue using them in the same way as in the past.

EXAMPLE

In 2012, the successor to Society Corporation was Key Corp. Analytically, Key Corp common stock, selling at \$7.89 per share has several characteristics similar to Society Corporation in the 1960s. At December 31, 2011, book value was \$10.24 per share. Key Corp had suffered mightily after the 2008–2009 economic meltdown, attributable mostly due to disastrous bank acquisitions the company had made in Sunbelt institutions heavily involved with residential mortgages and construction loans. In 2011 Key Corp was on the road to recovery. For the 12 months to June 30, 2012, Key's return on equity (ROE) was 8.6 percent. The calculation seems reasonable though, of course, uncertain. The important thing about Key seems to be that management avoids the mistakes it made in the early 2000s.

Good regional commercial banks such as Key have been attractive acquisition candidates in the post–World War II period, and the average acquisition price probably has been at least two times book value.

Assume, Key for the next five years enjoys an ROE of 10 percent per year, pays an average annual dividend of 20 cents per share, and after five years is acquired by a major bank (perhaps an International) at 2 to 2.5 times book value. The total returns to the investor would be as follows:

- Annual internal rate of return exiting at 2 times book: 34.7 percent.
- Annual internal rate of return exiting at 2.5 times book: 40.7 percent.
- Assuming no acquisition, book value per share would grow from \$10.24 at the end of 2011 to \$15.47 at the end of 2016 (at an 8.6 percent growth per year). If at the end of 2016, key common stock sold at book value, the internal rate of return based on a \$7.89 purchase price and 20 cent annual dividends would be 16.4 percent.

INFLUENCE OF REPORTED EARNINGS

ON COMMON STOCK PRICES

Although it is difficult to generalize about the role of current reported earnings as an influence on common stock prices, in buoyant general markets the main influences on common stock prices of companies that are strict going concerns seem to be:

1. Current reported earnings from operations and/or cash flows from operations.
2. Reported earnings and/or cash flows estimated for the immediate future.
3. Sponsorship.
4. Industry identification.

Greater weight tends to be given to earnings paid out as dividends than to earnings retained by the firm. There also tends to be an emphasis on trend, with great weight given to earnings that are going up.

To these earnings, a multiple—that is, a price-earnings (P/E) ratio—that is dependent on the above earnings record plus industry identification is applied.

It is important in these trading situations that not only should the company have a growth record; for its stock to attain a high multiple, it should also be situated in an industry that has a favorable image. Thus, a company with a less than good earnings record may attain a very high multiple if it is situated in a growth industry, whereas a company with steadily increasing earnings may sell at a very low multiple if it has an inappropriate industry identification.

Sponsorship also tends to contribute to the making of current stock market prices. *Sponsorship* means that a company is well regarded or is actually owned by interests with a history of Wall Street success. Sponsors can be all sorts of people and institutions, ranging from broker-dealers and private equity firms who have been imaginative and successful creators, such as KKR, Carlyle, Allen and Company, to people from outside the financial community who are deemed to have the magic touch, as, for example, John Malone, Barry Diller, Mark Zuckerberg. A company can attain a good industry identification through appropriate sponsorship, but sometimes such sponsorship can be substituted for industry identification. High levels of compensation from promoters and salespeople are an important reason for issuers to obtain sponsorship, such as the IPO phenomena during the dotcom bubble.

EXAMPLE

A good example of how effective industry identification can be is provided by looking at the comparative earnings of Broadcom Corp. (a developer of semiconductor solutions for the wireless industry) as of December 31, 2011, when its common stock was selling at 32.8 times current earnings, whereas at the same time AECOM Technology Corp. (a provider of professional technical and management support services for commercial and government clients worldwide) common stock was selling at 8.4 times earnings. Broadcom earnings record had been very spotty, but AECOM had shown steady annual earnings

increases for the prior six years. A comparison of their reported per-share earnings in the six years to December 31, 2011, is presented in [Table 5.1](#).

Table 5.1 Earnings per Share

Year	AECOM Technology Corp (NYSE: ACM) Earnings/Share	BROADCOM Corp (NASDAQ: BRCM)
2006	\$0.87	\$0.64
2007	\$1.12	\$0.37
2008	\$1.51	\$0.41
2009	\$1.74	\$0.13
2010	\$2.13	\$1.99
2011	\$2.28	\$1.65
Latest Price/LTM Earnings	8.3 ×	32.8 ×

Broadcom sold at over 32 times earnings because of its industry identification with the wireless industry, a growth industry. AECOM, on the other hand, is a diversified professional and technical service provider to commercial and governmental clients, and even though it had a much better earning power and growth history, it only sold just over 8 times earnings.

THE LONG-TERM EARNINGS RECORD

In fundamental analysis, special attention should be given to the importance of a favorable long-term earnings record for a strict going concern—that is, a company’s ability to have enjoyed, at least for accounting purposes, annual profits from operations over a period of three years, five years, and longer. Such a record or lack of it can be extremely important in many types of analysis, even though it lacks the universal significance attributed to it by some analysts for all corporate evaluations.

As will be discussed in the next chapter, there is an integral relationship between earnings records and asset values. The major component of net asset value for most publicly owned businesses is retained earnings—past profits that have not been paid out. There is a general tendency, therefore, for past records of profitability to be reflected in the net asset value reported in a company’s relatively recent balance sheets.

Over and above this, there are two types of analysis in which a company's long-term earnings record becomes especially significant. In the first, the business to be analyzed is to be viewed as a strict going concern, likely to conduct its operations in the future as it has in the past, and financed about the same as in the past, with management and control groups essentially unchanged.

The second area of analysis where a long-term earnings record becomes especially significant is in gauging the quality of an issuer. Where an operating business lacks consistent profits—indeed, where an issuer lacks long-term profits that have been on a rising trend—it lacks a crucial attribute necessary to rank as high quality. Securities of an issuer lacking a good earnings record frequently are highly attractive—as are, for example, resource conversion issues selling at depressed prices—but they are not generally recognized as high quality.

It should be reemphasized, furthermore, that many portfolios should be restricted in whole or in great part to high-quality issues (especially when the portfolio managers have neither know-how nor know-who) where a principal objective has to be the generation of regular cash income and where there are fiduciary obligations to the portfolio beneficiaries. In these instances, we suggest that suitable securities consist, at the minimum, of the issues of companies whose financial statements combine both favorable long-term profits records and strong present financial positions. We would not emphasize the long-term earnings record at the expense of the present financial position, or vice versa. However, if we had to pick one favorable factor most important in 2013, it would be strong financial position.

Given a three-pronged approach to the analysis of a company and its securities, certain shibboleths applied to strict going concerns become diluted when the business is analyzed not only as an operation but also as a financier. One strong example is the law of diminishing returns, which seem valid only when applied to strict going concerns. As such, companies keep increasing earnings, or cash flows become vulnerable to lower returns as the business becomes bigger and more unwieldy, and, if highly profitable, it tends to attract new competition. This law of diminishing returns seems far less applicable and even non-applicable when the company is to be appraised not as an operator but as an investor and a financier.

PARSING THE INCOME ACCOUNT

Earnings sometimes seem to mean all things to all market participants. Yet earnings are likely to be most valuable as analytical material insofar as more appreciation is gained of the various meanings of earnings. It is important to distinguish between the static equilibrium approach to earnings and the dynamic disequilibrium approach to earnings.

The static equilibrium approach to net income looks at current earnings and the earnings record as principal factors in the determination of what a current common stock market price ought to be. It is generally agreed that there tend to be equilibrium prices at a given moment for certain common stocks with certain current earnings and industry identifications, though in every instance there are important exceptions. For example, at this writing most electric utility common stocks are selling in a range between 10 and 12 times latest 12 months' earnings; most commercial bank stocks are selling in a range between 10 and 15 times earnings; and most savings and loan stocks are priced at from 10 to 20 times earnings. Say that a market participant uncovers a savings and loan concern selling at two times the latest 12 months' earnings. This fact could be the basis for investing in the common stock of the savings and loan company, assuming it is found after investigation that other things are roughly equal. This stock could have a reasonable appreciation potential if the tendency toward equilibrium prices took hold and if it were to sell in line with the P/E ratios at which other savings and loan stocks were selling.

The static equilibrium concept is not only important to outside investors, but also has a significant role in investment banking. Considerable use is made of the static equilibrium concept in the pricing of new issue underwritings. Managing underwriters usually attempt to price a new issue at a P/E ratio moderately below that at which the seasoned issues of companies in the same or similar industries are selling. Then, typically, the new issue is merchandised by emphasizing, among other things, that its earnings multiple is below that of comparable issues.²

The dynamic disequilibrium concept of earnings involves the use of the past and current record of reported earnings as a base for estimating future earnings. The projected increase in earnings is then used as a basis for predicting a future stock price. Thus, if a savings and loan common stock is selling at 7 and earnings are \$1 per share (or just about in line with seven times the industry P/E ratio), an analyst attuned to dynamic disequilibrium and estimating next year's earnings at \$1.50 might conclude that the stock will appreciate from 7 to 10.50, or seven times \$1.50 per share earnings.

We have already discussed in this chapter the uses and limitations of this pure dynamic disequilibrium approach. The analyst relying on earnings to evaluate a business or a common stock will be helped if he has some appreciation of the difference between the role of earnings in a static equilibrium approach and the role of earnings in a dynamic disequilibrium approach. It has been our experience that many analysts fail to distinguish between static equilibrium and dynamic disequilibrium.

It ought to be noted also that definitions of earnings, net income, or periodic earnings are usually not precise. We give several of the definitions that are used by various practitioners and scholars in different contexts. In each of these, earnings can be defined as:

- *What accountants computing results in accordance with Generally Accepted Accounting Principles (GAAP) report them to be.*

This is the most common definition of earnings used by others, and is most frequently but not always restricted by those with a stock market orientation to recurring earnings after income taxes from continuing operations.

- *What the accountants computing results in accordance with GAAP report them to be, as measured by overall performance, including extraordinary items and results of discontinued operations.*
- *The increase in value of a business (after adding back stockholder distributions) from one period to the next, with the increase measured by valuation tools that are not subject to GAAP assumptions and GAAP discipline.*

The best example of this is investment trusts, where "true" earnings results are measured by changes in net asset value, as measured by stock market prices adjusted for dividend distributions.

- *The increase in ability to make stockholder distributions over and above actual stockholder distributions, which do not reduce actual invested capital.*
- Such distributions to stockholders are usually in cash in the form of dividends, but they do not necessarily have to be so. The alternative method of distributing corporate cash to stockholders is to have a company repurchase its own shares for cash.
- *The increase in ability to make payments to all security holders, not just equity holders, during a period.*

Earnings can be measured by improvements in the overall financial position. An example of this can be found in the case of DPF, which had been a computer leasing company. From fiscal 1972 through fiscal 1975, DPF reduced its senior secured debt from \$28.3 million to \$965,000. During that period, aggregate losses for accounting purposes were reported at over \$4 million. For practical purposes, it was obvious that DPF was profitable in a meaningful economic sense, despite its reported loss for accounting purposes, because of its ability to achieve its prime objective of becoming better off by putting its financial house in order through the reduction of senior indebtedness.

- *The increase in ability to improve future sales, accounting profits, and/or cash flow during a period*

Earnings might be measured for a period in this case not by any reference to accounting results, but rather, say, by the perfection or development of a new product that has gained trade acceptance during its initial marketing.

The achievement of earnings as defined by GAAP does not even necessarily contribute to solvency. For example, in the early 1950s a new cigarette called Parliament, the original filter cigarette, was introduced by Benson and Hedges, then a very small cigarette company. Parliaments were inordinately successful, and Benson and Hedges expanded by leaps and bounds. Unfortunately for Benson and Hedges, working capital requirements ballooned, since in its industry it was (and is) necessary that cigarette tobaccos be aged for an average of three years. The faster the Benson and Hedges business expanded, the more difficult it was to finance its requirements for larger inventories. The more Benson and Hedges expanded as a small independent, the greater its accounting earnings were and the closer the company came to insolvency. As a small independent operator, Benson and Hedges' earnings were not "real." They could be made real only by selling out to an entity that could finance Parliament's expansion. Eventually, Benson and Hedges merged into Philip Morris, for whom Parliament's earnings were, of course, completely real, because Philip Morris had sufficient financial resources to benefit fully from the expansion that was taking place.

Reported accounting results and stock prices obtain such tremendous weight in many market calculations because they are the measurements that are both precise and visible. In an investment trust, one knows the value of the portfolio with precision, based on what the closing prices are and/or what the mean between bid and asked is (where no stock sale has occurred). Equity real estate investment trusts, on the other hand, may have a portfolio that would be readily convertible into cash over a period of a month or two, but because there is no daily price quotation for the real estate portfolio, its asset value can only be roughly estimated on any given day. Therefore, the value of the real estate asset portfolio is not given the same weight as the value of an investment trust portfolio, even though in the case of large investment trusts blockage would prevent liquidation of the portfolio in less than a few months' time at any prices other than those reflecting a large discount from market.³

Precision and visibility, even if they do not reflect realization values, deserve a special significance, because they appear to (and in a sense do) reduce uncertainties. An absence of precision and measurability usually, and understandably, detracts from perceptions of value.

Given the varied economic definitions of earnings, it may be wise to distinguish between earnings and earning power. By *earnings* is meant only reported accounting earnings. On the other hand, in referring to *earning power* the stress is on wealth creation. There is no need to equate a past earnings record with earning power. There is no a priori reason to view accounting earnings as the best indicator of earning power. Among other things, the amount of resources in the business at a given moment is likely to be as good or a better indicator of earning power. In 2012, a chaotic economic period, it tends to be highly important in common stock investment to pay special attention to the amount of resources in a business and how strongly that business is financed.

SUMMARY

The generation of reported net income and the creation of wealth are related: *the creation of reported net income is just one method of creating wealth*. There are many other ways of creating wealth that are separate and distinct from the generation of net income from operations, which we group under *resource conversion* activities. Where businessmen not involved with OPMI stock markets have choices, the generation of reported earnings from operations tends to be the least desirable method for creating wealth, simply because reported earnings from operations are less tax sheltered than are other methods of wealth creation. This is one of the reasons why resource conversion activities and financing activities by corporations seem to have grown in importance at

the expense of ordinary going concern operations. Publicly held corporations, however, frequently attempt to report the best earnings possible, not because businessmen think that current earnings per se are so all-important, but, rather, because the ability to report favorable current earnings may have the most favorable impact on stock prices and access to capital markets, which in turn may provide the greatest potential for wealth creation. Although difficult to generalize, in buoyant markets the main influence on the common stocks of companies that are strict going concerns seem to be the following: reported earnings, reported estimates of future earnings, sponsorship, and industry identification. These factors are used by conventional analyses to price common stock relative to others with the same characteristics (static equilibrium) or relative to forecasts of future earnings (dynamic disequilibrium). Given the varied economic definitions of earnings, it may be wise to distinguish between earnings and earning power.

* This chapter contains original material and parts of the chapter are based on material contained in Chapter 13 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (© 2006 by Martin J. Whitman and Martin Shubik), and ideas contained in the 2006 3Q letter to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ The concept of resource conversion is discussed in Chapter 2 and at length in Chapter 22.

² Examples are given in the discussion of Schaefer Corporation in Chapter 27.

³ Blockage occurs when a holder of a large block of freely tradable securities is unable, because of thin markets, to dispose of that block at any prices other than ones that are at a substantial discount from prevailing market prices.

CHAPTER 6

Net Asset Value: The Static and Dynamic Views*

[The Graham and Dodd View on NAV](#)

[The Financial Accounting View on NAV](#)

[Our View on NAV](#)

[The Usefulness of NAV in Security Analysis](#)

[The Importance of NAV Dynamics](#)

[NAV as One Measure of Resources](#)

[NAV as One Measure of Potential Liquidity](#)

[Limitations of NAV in Security Analyses](#)

[Large Premiums over Book Value Always Mean High P/E Ratios: It Depends on ROE](#)

[Net Nets Redefined](#)

[OPMI Investing in Companies with Growing NAVs](#)

[Summary](#)

In the analysis of any economic entity, a thorough researcher will look at valuations from both a static point of view and a dynamic point of view. The static approach centers on determining what the values are at this time, probably realizable by sale to a market or markets. The dynamic approach centers on estimating what future values are likely to be for the asset(s) in question. Both the static and dynamic approaches are essential to a net asset value (NAV) analysis.

In conventional security analysis, it seems as if the dynamic view of probable and possible future changes in NAV is all but ignored completely. This seems so even though in conventional security analysis—certainly in Graham and Dodd—the most important things to estimate are future earnings from operations and/or future cash flows. Further, in classical economics of the firm the principal thing to measure is not what exists as of a moment in time, but rather what changes are to be forthcoming. This in economics is called *marginalism*.

Book value is defined as a corporation's net asset value (NAV) per share as shown on the business's financial statements at a given date. Tangible NAV is defined exactly as is NAV, except that intangible assets (patents, copyrights, purchase good will, and so on) are excluded from assets. NAV is calculated by dividing net assets, that is, total assets minus total liabilities and outstanding preferred stocks taken at redemption value by the number of common shares outstanding.

NAV, unlike reported accounting earnings, seems to play little or no role in influencing day-to-day stock market prices. This is probably the principal reason why nearly all writers about financial accounting and security analysis have denigrated the importance of NAV as a tool of

valuation, emphasizing instead a primacy of earnings. We, on the other hand, believe that in almost all analysis outside of the day-to-day stock-trading environment, NAV is a highly useful tool of analysis for a variety of purposes, including predictions of future accounting earnings. In this chapter, we detail reasons why we think attention to NAV should be useful for creditors and investors.

A second reason why others treat asset values as less important than we do here is that they approach valuation solely from the point of view of outside passive minority investors (OPMIs) examining strict going concerns. Our interests, in contrast, are much broader, covering all securities holders, creditors, activists, and passivists. In addition, as explained earlier in this book, most businesses are rarely strict going concerns, but have both going concern and resource conversion attributes. Evaluations have to look at companies and managements not only as operators of going concerns, but also as investors and financiers.

Insofar as the approach to analysis is restricted to the evaluation of the securities of strict going concerns by OPMIs, it is understandable that there should be an emphasis on accounting earnings and/or cash flows at the expense of NAV. In such a situation, it is fair to conclude that the past earnings record is the best indicator of what is likely to happen in the future. The problem with this approach is not that it is not applicable in certain situations (for example, with an electric utility), but that it may be applied where it does not belong, as, for example, in the analysis of a domestic crude petroleum producer.

Before presenting our views about the importance of NAV in security analysis, its uses and its limitations, it may be helpful to review briefly the conventional views about the relationship between NAV and accounting earnings in security analysis and financial accounting. Typical among these conventional views are those contained in the books *Security Analysis*;¹ *Accounting Principles*;² *Corporate Financial Reporting in a Competitive Economy*, by Herman Bevis;³ and *Valuing a Company*, by McCarthy and Healy.⁴

THE GRAHAM AND DODD VIEW ON NAV

Graham and Dodd, in *Security Analysis*⁵ recognize that NAV is useful in certain cases. Nevertheless, in the analysis of most companies and in explaining stock market price behavior, Graham and Dodd place NAV in a decidedly secondary position, concentrating on earnings and dividends as the prime measure of management performance and company value. The Graham and Dodd views about asset value are most definitively articulated in Chapter 41 of *Security Analysis*, “The Asset Value Factor in Common Stock Valuation.”

In describing stock market behavior, Graham and Dodd point out that NAVs “lose virtually all significance.” Specifically, NAVs appear to them to have no relevance in determining earning power for industrial companies or railroads. Their studies show that market prices for rail and industrial common stocks had no correlations with NAVs: Some were sold at high multiples of NAV, others at discounts. Rather, Graham and Dodd found that market prices for these common stocks depended on the earning power and dividend payments of the company.

For Graham and Dodd, asset value is significant in special cases, not as a norm. For example, they find that NAV is a significant predictor of future earnings and stock prices for some companies; NAV is seen as an important stock price determinant for financial enterprises such as banks, insurance companies, and savings and loan holding companies, because assets used in these businesses tend to be highly liquid and readily turned into cash. Similarly, asset values are important in regulated public utility companies, where rates are set at least in part on the basis of asset value, so that the larger the company’s assets, the higher its potential earning power.

As a special case Graham and Dodd recommend that in evaluating risk or spotting unique opportunities, common stock investors should use NAV as a benchmark. They warn against common stocks selling at many times NAV as carrying inordinate risk. On the other hand, they point out that a common stock selling at only a “small fraction” of its NAV may have “speculative

possibilities especially so if there is no substantial debt.” Common stocks selling at a price well below NAV, earning power value, and past average market prices can be very promising, according to these authors. And if the stock price is below the value of the net current assets alone, then “it is almost an axiom either the price is too low or the management should change its policies in some respect.”

THE FINANCIAL ACCOUNTING VIEW ON NAV

Financial accountants universally seem to subordinate NAV to accounting earnings. Their definition of a “fair presentation” bottoms on a view that earnings ought to accurately reflect results for the accounting period. In *Accounting Principles* it is stated, “The information presented in an income statement is usually considered the most important information provided by financial accounting because profitability is a paramount concern to those interested in the economic activities of the enterprise.”⁶ Herman W. Bevis, former senior partner of Price Waterhouse and Company, states in his book, *Corporate Financial Reporting in a Competitive Economy*, “If one were forced to choose from among the financial statements which bears most directly upon the stockholder’s primary interest, it would, of course, be the income statement.”⁷ And McCarthy and Healy, in their book, *Valuing a Company: Practices & Procedures*, cite studies in a section titled “Lack of Significance of ‘Book Value’” which conclude that book values, or net equities, “lack . . . significance . . . as a valuation factor.”⁸

OUR VIEW ON NAV

We have a different emphasis from Graham and Dodd and the financial accountants. To us, NAV, in virtually all analysis other than predictions of common stock prices for the immediate future, is at least as significant as accounting earnings. And in practice, one is not a substitute for the other. But in choosing a starting point within financial statements for an analysis, NAV seems to us to be the better starting point most of the time than accounting earnings.

In part, our different emphasis results from different perspectives. Unlike Graham and Dodd and the financial accountants, we believe that a very large part of American businesses are engaged in resource conversion activities: That is, they are not strict going concerns involved only in operations that result in recurring accounting earnings. Rather, many companies, in whole or in part, are engaged in resource conversion activities that give rise to tax shelter, mergers and acquisitions, changes in control, liquidations, investment activities, and major refinancings. In support of this view, we present historical information about the prevalence of certain types of resource conversion activities for the companies in the Dow Jones Industrial Average Index for the five years from June 2007 through June 2012 in [Table 6.1](#).

Table 6.1 Resource Conversion Activities of Dow Jones Industrial Companies from June 2007 to June 2012

Company Name	Number of Private Placements	Number of Mergers/ Acquisitions
3M Co.	1	27
Alcoa, Inc.	1	6

American Express Company	5	6
AT&T, Inc.	1	18
Bank of America Corporation	4	64
Caterpillar Inc.	0	13
Chevron Corporation	0	24
Cisco Systems, Inc.	14	44
E. I. du Pont de Nemours and Company	2	16
Exxon Mobil Corporation	1	36
General Electric Company	5	17
Hewlett-Packard Company	0	24
Intel Corporation	1	27
International Business Machines Corporation	2	44
Johnson & Johnson	0	10
JPMorgan Chase & Co.	7	33
Kraft Foods Inc.	0	8
McDonald's Corp.	1	6
Merck & Co. Inc.	2	16
Microsoft Corporation	5	31
Pfizer Inc.	1	30
Procter & Gamble Co.	2	22
The Boeing Company	0	10
The Coca-Cola Company	1	12

The Home Depot, Inc.	0	3
The Travelers Companies, Inc.	0	0
United Technologies Corp.	0	3
Verizon Communications Inc.	2	4
Wal-Mart Stores Inc.	3	8
Walt Disney Co.	0	9

Table was built using S&P Capital IQ.

The analysis of businesses so engaged involves assigning a relatively increased importance to NAV, or in any event a marked decrease in the significance of accounting earnings from operations. In addition, Graham and Dodd and the financial accountants seem to view their constituency as OPMIs who are relatively conscious of, and influenced by, day-to-day stock market price fluctuations that are much more influenced by accounting earnings as reported than by NAV. We, on the other hand, view our basic constituency as creditors and investors, and insofar as we write for OPMIs, it is to recommend that they analyze securities in much the same way as do creditors and investors who are activists or promoters.

We also differ somewhat from Graham and Dodd and financial accountants because we have a different fundamental view about the relationship between NAV and accounting earnings. We believe that whenever accounting earnings are significant in the fundamental analysis of a company, so is NAV. Indeed, in most instances NAV is intrinsically related to earnings and exists in great part because companies or their constituent parts have enjoyed retained earnings in the past. In fact, our studies of stock prices show that when common stocks are selling at low price-earnings (P/E) ratios relative to average historic earnings, the same common stocks tend to sell at lower prices relative to NAV; conversely, high P/E ratios based on average historic earnings correlate with common stock prices that are at substantial premiums above NAV. Of course, there are logical reasons why this should be so.

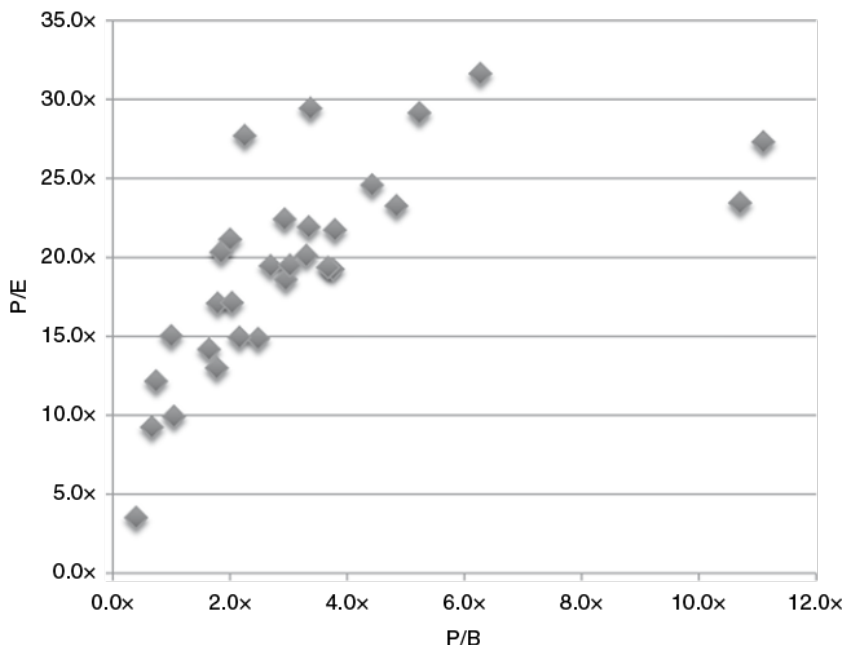
In the bookkeeping cycle, net income not paid out to stockholders becomes a balance sheet account, called retained earnings or earned surplus. These past profits tend to be the principal component of NAV. Thus, as a rule of thumb, companies with large NAVs relative to market prices have net worths that consist in great part of retained earnings. Such companies tend also to be selling at very low prices when compared with average long-term earnings.

For example, [Table 6.2](#) lists the 30 companies that comprise the Dow Jones Industrial Average, and shows the relation to the price for each company's common stock on June 2012, of its NAV and 10-year average earnings. [Figure 6.1](#) is a plot of the data in [Table 6.2](#).

Table 6.2 Relationship of Price on June 15, 2012, to Reported Ten-Year Average Earnings and Latest NAV for the Companies in the Dow-Jones Industrial Average

Company Name	Exchange:Ticker	P/B	P/E
Bank of America Corporation	NYSE:BAC	0.4×	3.5×
Alcoa, Inc.	NYSE:AA	0.7×	9.3×
Hewlett-Packard Company	NYSE:HPQ	1.0×	9.9×
JPMorgan Chase & Co.	NYSE:JPM	0.7×	12.2×
General Electric Company	NYSE:GE	1.8×	13.0×
Chevron Corporation	NYSE:CVX	1.6×	14.2×
Exxon Mobil Corporation	NYSE:XOM	2.5×	14.9×
Merck & Co. Inc.	NYSE:MRK	2.2×	14.9×
The Travelers Companies, Inc.	NYSE:TRV	1.0×	15.0×
Cisco Systems, Inc.	NasdaqGS:CSCO	1.8×	17.1×
Pfizer Inc.	NYSE:PFE	2.0×	17.1×
Johnson & Johnson	NYSE:JNJ	3.0×	18.6×
3M Co.	NYSE:MMM	3.8×	19.3×
Microsoft Corporation	NasdaqGS:MSFT	3.7×	19.4×
Procter & Gamble Co.	NYSE:PG	2.7×	19.5×
United Technologies Corp.	NYSE:UTX	3.0×	19.5×
American Express Company	NYSE:AXP	3.3×	20.1×
Kraft Foods Inc.	NYSE:KFT	1.9×	20.3×
AT&T, Inc.	NYSE:T	2.0×	21.1×
Caterpillar Inc.	NYSE:CAT	3.8×	21.7×
Wal-Mart Stores Inc.	NYSE:WMT	3.3×	21.9×
Intel Corporation	NasdaqGS:INTC	2.9×	22.4×
E. I. du Pont de Nemours and Company	NYSE:DD	4.8×	23.3×
The Boeing Company	NYSE:BA	10.7×	23.4×
The Home Depot, Inc.	NYSE:HD	4.4×	24.6×
International Business Machines Corporation	NYSE:IBM	11.1×	27.3×
Walt Disney Co.	NYSE:DIS	2.3×	27.7×
The Coca-Cola Company	NYSE:KO	5.2×	29.2×
Verizon Communications Inc.	NYSE:VZ	3.4×	29.4×
McDonald's Corp.	NYSE:MCD	6.3×	31.6×

Figure 6.1 Relationship of Price on June 15, 2012, to Reported Ten-Year Average Earnings and Latest NAV for the Companies in the Dow-Jones Industrial Average



This correlation between P/E ratios based on accounting earnings and the relation of market price to NAV has not always been fully appreciated. For example, see the comments of McCarthy and Healy cited on page 184. Yet, we have found that there is a strong tendency for stocks selling at high multiples of historic earnings also to be selling at substantial premiums above NAV. This correlation between P/E ratios and the spread between market price and NAV is not perfect, of course. The correlation does exist, however, as a general rule. Given the integral relationship between historic accounting earnings and NAV, we would be surprised if it did not. To say, then, that earnings determine common stock prices but that NAV is irrelevant clearly makes no sense unless one is talking only about short swing trading and stock price movements.

THE USEFULNESS OF NAV IN SECURITY ANALYSIS

Since we place more emphasis on NAV as a tool of analysis than do most other commentators, it is only appropriate that in reviewing its values and uses we also comment briefly on its limitations.

First, NAV is an accounting number, and in its usefulness and reliability it has to be as limited a tool of analysis as financial accounting itself. Second, NAV alone does not mean much; it has to be related to other numbers and other concepts in order to become significant. Third, in conventional security analysis it seems as if the dynamic view of probable and possible future changes in NAV is all but completely ignored. The most important part of NAV analysis is the understanding of its dynamics. Finally, NAV is a *quantitative* measure of net assets: it tells us how much. In using a fundamental finance approach, however, *quality* of assets tends to be more important than quantitative considerations. Later in this chapter we discuss the characteristics that give assets desirable or undesirable qualitative characteristics and provide a “redefinition” of Graham and Dodd’s concept of net assets based on judgments about the *quality* and *quantity* of assets

separate and distinct from their classification on the GAAP balance sheet.

Net asset value (NAV) has special merits both as a dynamic tool of analysis and a static one. The merits of NAV as a dynamic tool of analysis are:

- As a comprehensive measure of the wealth creation capability of a business
- As an appraisal of companies and managements as operators, investors, and financiers

The merits as a static tool are as follows:

- As one measure of the resources available to a business
- As one measure of potential liquidity available to a business

THE IMPORTANCE OF NAV DYNAMICS

In understanding a business, as distinct from predicting near-term common stock prices, predicting changes in NAVs tends to be far more important than making earnings estimates. In making earnings estimates, companies are being analyzed and managements are being appraised, solely as strict going concerns emphasizing only recurring operations. To understand a business a responsible analyst has to appraise an economic entity and their managements from three perspectives.

1.As operators of going concerns.

2.As investors employing and redeploying a company's assets in mergers and acquisitions, spinoffs, liquidations, changes in control.

3.As financiers engaged in all sorts of activities ranging from going private, incurring debt, making cash distributions to shareholders, going public via IPOs.

To analyze businesses as operators, investors, and financiers, the analyst has to look at the entire accounting cycle—income account and balance sheet—and just not place greater emphasis on the income account. The best accounting measure of the results of three activities are changes in NAV after adding back dividends.

In the static approach, there are certain types of assets where reported accounting numbers give a good indication of NAV and certain types of assets where the accounting numbers seem unhelpful in estimating NAVs. In attempting to ascertain NAVs attributable to a common stock, it seems harder to get good estimates of NAV where the business being analyzed has to service large amounts of debt. A rough list of where certain types of assets serve as good approximation of NAV and where there are poor approximations are as follows:

Where Accounting Disclosures Are a Good Measure of NAVs

- Investment companies.
- Income-producing real estate especially where the accounting discipline is International Financial Reporting Standards (IFRS) rather than GAAP. Under IFRS independent appraisals of income-producing real estate properties is required. Insofar as the appraisal relies on the income approach to valuation (as all appraisals do) the valuation will also give reasonable estimates of what future cash flows are likely to be with the principal uncertainty usually revolving around predicting future capitalization rates rather than future flows.
- Portfolios of performing loans whether accounted for as available for sale

- or at amortized cost (most insurance companies and bank portfolios).
- Companies holding marketable securities where the company has control over the portfolio companies or elements of control (Toyota Industries, Investor A/B, Wheelock and Company).

Where Accounting Disclosures Tend to Be a Poor Measure of NAVs

- Single-purpose assets dedicated to a going concern (General Motors, Chrysler, steel companies)
- Retail operations (Sears Holdings, JC Penney)
- Exploration and production companies especially those whose values depend in large part on unproved reserves and acreage holdings
- Extractive industries
- Start-ups
- New inventions

A buy and hold investor focused on owning the common stocks of companies that will grow NAV after adding back dividends, will tend to acquire such common stocks after examining four elements:

1. Does the company enjoy a super-strong financial position?
2. Can the common stock be acquired at a price that represents a meaningful discount from NAV, say at least 20 percent?
3. Will the company be able to grow NAV (after adding back dividends) over the next five years at no less than 10 percent per annum compounded?
4. Are there catalysts, such as possible changes of control, which will result in a diminution or elimination of the discount from NAV?

The first two factors are easy for the analyst to ascertain. The third factor—growth in NAV—requires a lot of analytic judgment. However, many, many companies have met the 10 percent growth bogey during the period 2007–2012, a period marked by the Great Recession. Companies that have grown NAV by much more than 10 percent compounded (Brookfield Asset Management and Wheelock and Company both exceeded 20 percent) during this period include Berkshire Hathaway, Brookfield Asset Management, Hang Lung Properties, Henderson Land Development, POSCO, Wharf Holdings, White Mountains Insurance Group, and Wheelock.

For the investor, growth in NAV can be an almost assured source of profit, or an absence of loss. The one way to lose in owning such common stocks, provided one is reasonably good at estimating future growth in NAV, is if discounts from NAV widen dramatically from the 20 percent discount at which the common stocks were acquired.

EXAMPLE

Acquire a non-dividend paying common stock at 8 when the NAV is 10. Hold the issue for five years. If the NAV growth is 20 percent compounded for the five-year period, NAV at the end of the five-year period will be \$24.88 per share; at 15 percent compounded, the NAV would be \$20.11 per share and at 10 percent the NAV would be \$16.11. The cost basis for an investment would have been 8 per share

or a discount of 20 percent from the opening NAV of 10 per share.

For the 20 percent growth issue to result in a break-even at the end of 5 years, the discount would have to widen to 67.8 percent; to result in a break-even for the 15 percent growth issue, the discount would have to widen to 60.2 percent; and to result in a break-even for the 10 percent growth issue, the discount would have to widen to 50.3 percent.

Such wide discounts seem rare, but they do occur from time to time given that the general market seems to utterly ignore growth in NAV. At this writing, for example, Wheelock and Company common sells at a 50 percent discount from latest reported NAV, and Lai Sun Garment common sells at an 81 percent discount from latest reported NAV.

EXAMPLE

Companies like Cheung Kong Holdings Limited and The Wharf Holdings Limited (both Hong Kong issuers) are examples of what we just wrote about. [Table 6.3](#) shows that Cheung Kong Holdings NAV per share has grown for the last seven years at a 9.2 percent annually compounded rate, while The Wharf Holdings NAV per share grew at a 16.7 percent per year rate.

Table 6.3 Annual per Share NAV, Growth Rate, per Share Market Price and Premium (Discount) to NAV, in HKD

Year	Cheung Kong			The Wharf Holdings		
	EOY NAV/ Share + DIV	NAV/ Share G. Rate	Premium (Discount)	EOY NAV/ Share + DIV	NAV/ Share G. Rate	Premium (Discount)
2007	100.54	13.3%	-1.7%	36.08	14.5%	5.5%
2008	99.65	-0.9%	43.6%	36.93	2.4%	-48.8%
2009	107.65	8.0%	-31.3%	47.68	29.1%	-15.9%
2010	119.37	10.9%	-16.2%	60.22	26.3%	-9.3%
2011	137.47	15.2%	-8.6%	68.16	13.2%	-49.2%
CAGR		9.2%			16.7%	

A basic reason for owning these common stocks is that we believe the prospects appear to be good that NAVs will grow over the next five to seven years at rates of not less than 10 percent per annum compounded. NAV growth provides ample margin of safety and potential market performance as shown in [Table 6.3](#). In 2009 an investor could have bought Cheung Kong Holdings common at a near 30 percent discount from readily ascertainable NAV. By 2011, Cheung Kong Holdings NAV had grown by 28 percent, and the market discount to NAV had narrowed to only 6 percent yielding nearly a 70 percent return on the investment excluding dividends. In 2008, The Wharf Holdings common could have been purchased at an almost 49 percent discount from readily ascertainable NAV. By the end of 2011, NAV per share had grown by 86 percent, but the discount to NAV had remained roughly the same. The investor following the fundamental finance approach and restricting his investments to heavily discounted securities would have netted an 83 percent return on his investment excluding dividends.

Even in cases when the growth projections for NAV fail to materialize, purchasing common stocks at significant discounts from readily ascertainable NAV

does provide a meaningful margin of safety.

EXAMPLE

By the end of 2006 an investor could have purchased Capital Southwest Corporation common at a price that represented almost a 34 percent discount to NAV per share. Back then the prospects seemed to favor the assumption that Capital Southwest would grow readily ascertainable NAV by at least 10 percent per year for the foreseeable future. Over the following six years NAV did not grow as expected as shown on [Table 6.4](#).

Table 6.4 Annual per Share NAV, Growth Rate, per Share Market Price and Premium (Discount) to NAV

Fiscal Year*	Capital Southwest Corp.			
	EOY NAV/ Share + DIV	NAV/ShareG. RATE	Price/Share	Premium (Discount)
2006	144.56	33.4%	95.50	-33.9%
2007	188.35	30.3%	153.67	-18.4%
2008	150.69	-20.0%	123.72	-17.9%
2009	111.78	-25.8%	76.39	-31.7%
2010	130.94	17.1%	90.88	-30.6%
2011	144.48	10.3%	91.53	-36.6%
2012	168.25	16.5%	94.55	-43.8%
CAGR		2.6%		

*March 31 end of fiscal year.

The NAV per share by the end of fiscal 2012 was 16.4 percent higher than it was at the end of fiscal 2006, corresponding to a 2.6 percent annual compounded rate of growth. Moreover, the market discount to NAV had widened considerably from 34 percent to 44 percent. Even in light of these adverse developments, the fundamental finance approach provided the investor with a rather substantial margin of safety. The price at the end of fiscal year 2012 was about the

same as the price at the end of fiscal 2006.

The outside investor who purchases securities regardless of the immediate outlook will probably always be in a distinct minority among securities purchasers. Such an investor must be in a strong financial position. He must also be capable of curbing any tendencies toward greed in his investment: He cannot attempt to buy precisely at the bottom of the market or to maximize capital gains over short periods. Finally, he must be convinced that there are important values in the company whose stocks he holds that are not reflected in the market price and are not likely to be dissipated. Without such conviction, almost any investor can be expected to panic if the market price of the security he holds declines. It tends to be much easier for outsiders to gain some degree of conviction if a cornerstone of their analysis is an approach that emphasizes high-quality NAV acquired at a discount price.

Changes in earnings can be sudden and violent, and changes in price-earnings ratios even more so. Changes in NAV, on the other hand, by definition are almost always more gradual. A large, relatively unencumbered NAV may be an anchor to windward, both for the company with honest and reasonably competent management and for the OPMI who holds its common stock. Under the conditions prevailing in 2012–2013, for the vast majority of common stock portfolios, we recommend that the investor hold no less than 50 percent of his/her portfolios in these types of issues.

NAV AS ONE MEASURE OF RESOURCES

Even where the past earnings record of a company is a superior indicator of future earning power, we know of no instance in which it has been the sole indicator. The amount of resources a management has available to create future earnings remains an essential indicator of future earning power. And one measure of available resources is NAV.

This approach is more commonly used in the context of corporate takeovers (such as mergers and acquisitions) than it is in the context of passive investing by OPMIs. Corporate buyers tend to be acutely conscious of how they plan to use the resources over which they gain control in order to maximize earning power. OPMIs, on the other hand, are not in a position to alter the way a corporation's resources are used, and understandably are thus less likely to use this resource conversion approach in forecasting future earnings. It does not follow from this, however, that an OPMI should or can safely ignore NAV in analyzing a corporate situation. If only because corporate acquirers are using NAV analysis in this fashion, the OPMI may be able to reap a substantial benefit from adopting this kind of approach.

NAV as a measure of resources is also crucial in any kind of return on investment (ROI) or return on equity (ROE) analysis.⁹ ROI and ROE analyses are important tools in forecasting future earnings.

EXAMPLE

High ROI may mean that a company has a proprietary position that will allow it to continue to enjoy above-average profitability; alternatively, it may be an invitation for new competition to enter the industry and drive down profits for all. Conversely, low ROI may evidence an overvaluing of assets and inefficient

management, or it may be an indication that the business has a large amount of unused resources that give it a margin of safety and the wherewithal to expand earning power.

Many analysts recognize the importance of ROI and ROE analyses and place considerable emphasis on them while disclaiming the importance of NAV. But you cannot calculate a return on investment unless you know the amount of the investment; nor can you know the amount of the investment unless you know the amount of the net worth. Inasmuch as NAV measures common stock equity, which is a component of net worth, it must necessarily figure in this calculation.

NAV AS ONE MEASURE OF POTENTIAL LIQUIDITY

Liquidity is a qualitative characteristic of assets, and as such is discussed later in this chapter. Conventional strict going concern analysis focuses on balance sheet liquidity by relating current assets—especially cash, marketable securities, and other assets readily convertible into cash—to liabilities. Such analysis is appropriate only in the strict going concern case. However, in the real world of resource conversion and the tax carryback provisions of the U.S. Internal Revenue Code, large quantities of brick and mortar assets are frequently the raw material out of which a great degree of liquidity is created.

With variations to allow for differences between financial accounting and income tax accounting, the book-carrying basis for assets is often close to the tax cost-carrying basis for those assets. If so and if certain other conditions prevail: namely, that a profitable business has been a taxpayer at relatively high tax rates, and the company's assets that are used in operations decline materially in value, then opportunities exist to use tax carrybacks to create cash benefits for the company and/or the stockholders of a company that sells its assets, and for a buying entity and its stockholders.

Under the U.S. Internal Revenue Code, in many situations where a company sells to an unrelated party assets used in the trade or business (whether they are current or fixed, from an accounting point of view) for less than the tax basis of those assets, the selling company will have realized a loss for tax purposes subject to offsets, namely, possible tax recapture of investment tax credits and accelerated depreciation. This loss after offsets is usually treated under Section 1231 of the Internal Revenue Code as an ordinary loss, even though the assets are considered capital assets. With an ordinary loss, the company can then obtain a quickie refund under the tax loss carryback provisions of the Internal Revenue Code. A quickie refund results in a cash payment to the company, within 45 days after the end of the tax year, up to the income taxes paid for the current year and the two immediately preceding years. During the 2008–2009 meltdown the tax loss carryover provisions were extended to five years so that previously profitable companies that suffered huge losses in 2008–2009 (e.g., homebuilders) could get massive cash refunds from the Internal Revenue Service.

This tax loss carryback feature is especially useful when a profitable business is available for acquisition at a price well below net asset value as shown on the tax records. In that case, the Internal Revenue Service will probably provide a substantial amount of the cash needed to finance the acquisition.

Examples of such transactions abound. They include the purchase of Cletrac by White Motors; of American Viscose by FMC; of New York Trap Rock by Lazard Freres and Lone Star Cement; and the 1975 sale by Indian Head of its textile operations to Hanson Trust. Budd Manufacturing bought Continental Diamond Fiber assets in the late 1950s, and Fiber used the tax carryover to finance the

expansion of the one small operation that Budd did not buy. That small operation became Haveg Industries, which was eventually valued at over \$50 million when it merged into Hercules.

The mechanics of such a tax loss carryback transaction can be best explained by a relatively simple example that assumes there are no recapture offsets.

EXAMPLE

Assume that the common stock of Target Company, which has a NAV for financial statement and tax purposes of \$44, is selling at \$15, or $7\frac{1}{2}$ times earnings. Target has earned an average of \$4 per share before taxes (\$2 per share after taxes, based on a 50 percent tax rate) for the last four years. The company's assets include \$3 cash per share, and Target is virtually debt free.

Let's say that Acquirer Company, which has had no prior relationship to Target, purchases after negotiations all of Target's assets except its cash, and also assumes all of Target's liabilities by paying to Target \$23 cash per share. In order to accomplish this, Acquirer is able to borrow \$18 of the cash per share from an insurance company.

Supposing that Target incurs \$1 per share expense for this transaction and its subsequent liquidation, Target's workout value for the common stockholders will be \$31 per share. This is shown in [Table 6.5](#). Target's assets available for liquidation consist of \$23 per share in cash received from Acquirer on the sale of its assets, plus \$3 per share of Target's own cash, plus an extra \$2 per share of current-year income due to tax savings, plus a two-year NOL carryback plus current year's taxes that generates refunds of prior income taxes paid of \$2 per share per year for a total of \$6 per share, minus \$1 per share for deal expenses. The \$31 per share distributed in liquidation to Target shareholders amounts to a 107 percent premium over the then market price of \$15.

Table 6.5 Target Company Workout Value on Liquidation

Item	Per Share
Cash not sold to Acquirer Company	\$3
Cash received on sale to Acquirer Company of assets, subject to all liabilities	\$23
Carryback of Target's current-year income taxes, plus three years' prior income taxes at \$2 per share per year	\$6
Subtotal	\$32
Less Target's liquidating expense	\$1
Liquidation value per share	\$31
% premium over workout over market of \$15	107%

From the buying entity's point of view, Acquirer was able to purchase the Target business at a price to it of \$31, using only \$5 of its own resources. The rest of the purchase price was other people's money—\$18 borrowed from an insurance company and \$6 obtained from the tax refunds.

Consummation of this transaction and the subsequent liquidation would result in Target's stockholders receiving a substantial premium over the market value of their shares. If Target wants to liquidate, it can do so by distributing \$31 in cash to its stockholders. This liquidation would have no tax consequences to Target itself, provided that under Section 337 of the Internal Revenue Code a liquidation was substantially consummated within 12 months after the adoption of a plan of liquidation. Rather, the liquidation would be a taxable event for the stockholders: Each stockholder would have a capital gain or capital loss, depending on the cost basis each had for his common stockholdings. Target, however, need not necessarily liquidate. If management wanted to continue in business, Target might become an investment trust, or it might be able to buy certain other businesses.

Target did not necessarily have to sell all its assets to Acquirer. It could, for example, have retained one operation and offset taxes on profits from that

operation against the loss carry forward created by the sale of assets.

On a *pro forma* basis, Acquirer's equity bought Target's net assets at around three times earnings, based on Acquirer's equity investment of \$5, although Target's P/E ratio as an independent company was $7.5\times$. Table 6.6 shows a condensed *pro forma* balance sheet for Acquirer, based on the acquisition of Target's net assets. Acquirer, if it were a public company, might also benefit because its purchase of Target's net assets at a price below NAV enables it to report higher earnings on the operations than Target had. This result is due to one factor: because Acquirer's cost basis for the assets is lower than Target's.

Table 6.6 Acquirer *Pro Forma* Balance Sheet (On a Per Share Basis)

Assets purchased from Target	\$30	Assumption of Target liabilities	\$7
		Insurance company loan	\$18
		Equity Investment	\$5
	\$30		\$30

Table 6.7 illustrates a condensed income account for Acquirer, based on its having the same operating earnings before depreciation from Target's assets that Target had actually experienced in the prior four years.

Table 6.7 Target Company Workout Value on Liquidation

Pretax earnings as reported by Target	\$4.00
Reduced depreciation attributable to Acquirer (because assets have lower cost basis)	\$1.00
Subtotal	\$5.00
Deduct interest at, say, 7% on \$18 million loan	\$1.26
Pretax earnings	\$3.24
Taxes at 50% ^(A)	\$1.62
Net Income	\$1.62
Acquirer P/E ratio based on equity investment of \$5 and after tax earnings of \$1.62	3.1×

^(A) Cash benefits to Acquirer would be even greater if Acquirer had a usable tax-loss carry-forward.

^aTarget's becoming an investment trust is a principal component of a form of transaction that has come to be known as the most common type of leveraged buyout. In this type of leveraged buyout, three elements are present. First, assets are purchased at, or below (hopefully below, so that tax refunds may be obtained), their tax cost basis, so that no tax liabilities are created regardless of how low the cost basis for common stock held by principal stockholders may be. Second, the acquiring company hires the operating management of Target, giving them attractive long-term contracts, to run the business represented by the assets the acquiring company has purchased. Third, Target converts into an open-end investment trust, that is, a mutual fund, whose investments are restricted to tax-free securities issued by city and state governments. Target then offers to redeem shares at net asset value (\$31 per share in [Table 6.5](#)), at which time most public shareholders redeem and principal stockholders do not. The principal stockholders then control a mutual fund which has invested in tax-free obligations and which flows through without taxation all interest received to the remaining shareholders of Target. In effect, then, principal shareholders have converted their active business interests into a

portfolio of tax-exempt securities without incurring any income tax liabilities even though their cost basis for their common stock holdings may be zero or close to zero.

LIMITATIONS OF NAV IN SECURITY ANALYSES

To repeat, we do not believe in acquiring securities solely on the basis of the earnings record of a company or on the outlook for its reported earnings. Neither do we think that an investment program based on acquiring securities simply because they are available at large discounts from NAV would necessarily be well advised. Availability at a large discount from book does give a first approximation that a security may be a bargain, or even that it may be attractive according to the fundamental finance approach. But this first approximation ought to be tempered by a more thorough analysis. In order for NAV to be a good indicator of the wealth or future earning power of a business, other factors must be considered as well.

A company's record of profitability is, of course, some indication that the book asset value actually reflects real operating wealth, in the sense of assets that provide the wherewithal for obtaining earnings. Earnings for the current and the three prior years may also be a potential source of liquidity if income taxes have been paid or tax liability has accrued on them. The investor should also consider such factors as the size of the company's operational overhead and the incentives for control groups to work against the interests of the outside stockholders. Also, since NAV is only an accounting figure, it cannot be more useful than accounting figures in general. In our view, the most important limitation of the usefulness of NAV as an analytical tool is that in itself, it does not measure the *quality* of a company's assets, which we believe tends to be significantly more important than the quantity of asset value. Unfortunately, *quality* is a less measurable and less precise concept than quantity, involving what is essentially a subjective judgment.

What do we mean by *quality of assets*? We suggest that *quality* of assets is determined in a corporate situation by reference to three separate, but related, factors:

- 1.Assets owned free and clear of encumbrances
- 2.Quality of operations
- 3.Nature of assets themselves

An asset or mix of assets has high-quality elements insofar as it approaches being owned free and clear of encumbrances. Conversely, the assets of debt-ridden companies tend to be of low quality. Note that though encumbrances that depress the quality of assets (such as long-term indebtedness) may be stated liabilities, they may also be off-balance-sheet items, some of which, of course, will be disclosed in footnotes to the company's financial statements. These include such items as pension plan liabilities, and such contingent liabilities as litigation and guaranties of the debts of others.

EXAMPLE

Over the period from December 2007 to the end of calendar 2011, The Boeing Company per share NAV

(including dividends) shrunk at slightly more than 2 percent per year while many other Dow Jones Industrials' components experienced increases of upwards of 10 percent per year for the same period. Pension and other postretirement benefits grew the other comprehensive loss account by almost a 15 percent per year rate while wealth generated either through going concern operations and/or resource conversion activities remained flat for the period.

Other encumbrances may be disclosed elsewhere. For example, a steel mill may be required to install antipollution equipment that does not generate revenue. Still other off-balance-sheet encumbrances may not be disclosed in any public document. A common example would be the need to substantially overhaul outdated plants and equipment in order for the business to remain competitive enough to survive. Unless an investor has know-how, and perhaps even know-who, he may be unable to find out that such encumbrances exist.

The second factor to consider in evaluating the quality of assets of a going concern is its operations. Does it have a mix of assets and liabilities that appears likely to produce high levels of operating earnings and cash flows? Good operations are an important creator of high-quality assets and are likely to contribute to a company's having a strong financial position. Lenders quite properly prefer to finance businesses whose operations are sound and who are likely to create the wherewithal for continuing debt service on a long-run basis.

The third factor the investor must consider is the nature of the assets themselves. An asset or mix of assets tends to have high quality when it appears to be salable at a price that can be estimated with a modicum of accuracy. In many strict going concern situations, no separate values may be assigned to specific assets as a practical matter, because they may be useful only as a part of the operations of the company. A microchip manufacturing plant may be very valuable to the operations of a business but may have little or no value as a separate asset for sale. On the other hand, proved reserves belonging to an exploration and production company can be valued with a modicum of effort and do have value outside of the going concern either through a sale to a third party, monetization through entering into volumetric production payment agreements, or used as collateral in secured borrowing.

First and foremost, then, for an asset to have independent value from the point of view of the outside securities holder, it must be available for sale apart from the operations of the going concern. It must be something that is not so related to the going concern operation, or if so dedicated, is separable from it in a manner that will not have an adverse impact on the operating earnings power of the going concern.

Aside from this freedom from a going concern encumbrance, there are certain other characteristics that tend to make assets more attractive to lenders, and thus of higher quality. Assets that are liquid and marketable tend to be more attractive to lenders than those that are not. Liquid assets include cash and equivalent marketable securities, including restricted securities with meaningful rights of registration, proved oil and gas reserves, cutting rights and timberlands, and various types of real property. In order to be marketable, the assets must have a value that is readily measurable. In the case of securities that are traded in organized markets, the market provides a measure of value. Other assets may have readily ascertainable values even though not so traded—as, for example, income-producing real estate.

If an asset is one that third-party lenders or guarantors (such as financial institutions and governments) are experienced in lending against, the standards they have developed for lending may also provide a measure of value, and the asset tends to be more valuable than it would otherwise be. Examples of such high-quality assets have included oil and gas, maritime vessels and certain types of real estate.

Flexibility and scarcity are factors that tend also to make an asset more valuable. Thus, multipurpose assets tend to be more valuable than single-purpose assets. Flexibility is especially important in the case of real estate: A factory useful for only one type of assembly line production tends to be less attractive than, say, a downtown hotel that can be converted economically into efficiency apartments. Assets that are scarce, at least on a long-term basis (such as copper mines or domestic oil), may have special values all their own.

Certain assets that appear to have these characteristics may, of course, not have them because of legal impediments. For example, U.S. margin regulations make publicly traded common stocks worse collateral than other assets that lack common stocks' characteristics of liquidity, marketability, flexibility, and measurability. Other assets may have special value because they can be used to create tax shelter. Because tax savings allow these assets to throw off more cash, tax-sheltered assets tend to be most attractive in the eyes of creditors. Thus, assets such as real estate, timberlands, to some extent oil and gas as well as other natural resources, have been outstanding examples of this.

These three factors—the amount of encumbrances, the operations, and the nature of the assets themselves—tend to be interrelated and may be offsetting. Thus, a company that is less encumbered tends to be freer to invest in assets lacking high quality. The property and casualty insurance industry provides a good example of this: Where an insurer's capital and surplus are small relative to stated liabilities (and to premium income, which in turn tends to be related to the size of liabilities), that insurer will concentrate its investments in government and investment-grade corporate debt instruments. Only as capital ratios improve relative to stated liabilities (and premium income) will insurers tend to invest a portion of their assets in such lower-quality instruments as equity securities, especially common stocks.

High-quality asset businesses tend to be far more attractive holdings at given prices—say, when the common stocks are selling at ten times earnings—than are comparable businesses with lower-quality asset values. This is so because such businesses have a tendency to be subject to certain dynamic developments. And frequently the common stocks of businesses with high-quality assets may sell at lower P/E ratios than comparable businesses with lower-quality assets. This tends to happen when stock traders desire to pay premiums for aggressive managements, although companies with high-quality assets oftentimes are run by careful rather than aggressive managers.

High-quality assets are most commonly used to finance rapid growth, both in present product lines and into diversified areas—as, for example, in the case in 2012 for Brookfield Asset Management or Cheung Kong Holdings.

Surplus liquid assets not needed in a business (sometimes called surplus surplus¹⁰) may be extracted from these companies. This was, for example, the basis of the takeovers in 1968 and 1969 of strongly capitalized insurers, such as Reliance Insurance and Great American Holding Company. At the time of takeover, the workouts for shareholders were more than twice what the shares had been selling at one year earlier.

A company's high-quality assets may be used to finance the takeover of that company on a better price basis than would otherwise be available. An example of this—a case where a mouse swallowed an elephant—was the 1962 acquisition by Albermarle Paper Manufacturing Company, a small company, of the entire capital of the much larger and extremely well financed Ethyl Corporation. Albermarle not only swallowed the elephant, but also adopted its name.

When a company lacks encumbrances as measured against the amount of obligations it owes, the nature of its operations and/or its potential to sell or convert all or part of its assets to a more liquid or useful form, that company is deemed by us to have a strong financial position, one of the four main characteristics sought in an equity investment using the safe and cheap approach. Generally, it is our view that if a company has little or no outstanding obligations, it is in a strong financial position, unless operating losses seem to have some prospect of being so large that the company's strength will be impaired.

Value investors, by definition, are conscious of the relationship of securities prices to corporate fundamentals. In value investing, asset allocation is driven more by price considerations and less by predicting outlooks.

LARGE PREMIUMS OVER BOOK VALUE USUALLY MEAN HIGH P/E RATIOS: IT DEPENDS ON ROE

When common stocks are selling at ultra-high premiums over book value, it is hard to acquire securities at reasonable P/E ratios. This can only be accomplished if the issuer enjoys unprecedently high returns on equity (ROE), say well in excess of 30 percent. In fact, most companies rarely achieve ROEs in excess of 25 percent most of the time. In our recommended list of common stocks in [Table 6.11](#), the goal for the issuer, as measured by ROE is to achieve growth of 10 percent per year after adding back dividends, over a 3- to 7-year period.

The above can be demonstrated by a simple example. Assuming a market price of $6\times$ book value, P/E ratios at various ROEs would be as follows:

Table 6.8 Relationship between ROE and P/E Ratios under a $6\times$ Book Pricing Assumption

Market Price	Book	ROE	EPS	P/E Ratio
\$6	\$1.00	25%	\$0.25	24.0×
\$6	\$1.00	20%	\$0.20	30.0×
\$6	\$1.00	15%	\$0.15	40.0×
\$6	\$1.00	11%	\$0.11	54.5×

The $6\times$ book value might be justifiable assuming that a company has such attractive access to capital markets that it could increase their number of shares outstanding by 31.5 percent via the issuance of new shares at $5.25\times$ book either in an acquisition or a public offering. (This assumption is probably unrealistic for most companies most of the time.) In that instance book value would increase to \$2.02 per share,¹¹ and EPS and P/E ratios would be as shown in [Table 6.9](#) for various ROEs (forgetting the probabilities that the increased equity base might well precipitate a decline in ROE). This is part of our thesis that in the hands of an astute management an overpriced common stock can be a most important asset.

Table 6.9 Relationship between ROE and P/E Ratios Under a Doubling of Book Value Assumption

Market Price	Book	ROE	EPS	P/E Ratio
\$6	\$2.02	25%	\$0.51	11.9×
\$6	\$2.02	20%	\$0.40	14.9×
\$6	\$2.02	15%	\$0.30	19.8×
\$6	\$2.02	11%	\$0.22	27.0×

NET NETS REDEFINED

Net asset values are readily ascertainable insofar as the specific assets consist of cash and equivalents; investments in marketable securities and performing loans; income producing real estate; land suitable for development; and intangibles such as mutual fund assets under management. Rarely (except for cash and equivalents) are these readily ascertainable asset values classified as current assets under Generally Accepted Accounting Principles (GAAP). Graham and

Dodd describe net nets in the 1962 edition of *Security Analysis* on pages 561 and 562:

We feel on more solid ground in discussing these cases in which the market price or the computed value based on earnings and dividends is less than the net current assets applicable to the common stock. [The reader will recall that in this computation we deduct all obligations and preferred stock from the working capital to determine the balance for the common.] From long experience with this type of situation we can say that it is always interesting, and that the purchase of a diversified group of companies on this "bargain basis" is almost certain to result profitably within a reasonable period of time. One reason for calling such purchases bargain issues is that usually net current asset values may be considered a conservative measure of liquidation value. Thus as a practical matter such companies could be disposed of for not less than their working capital, if that capital is conservatively stated. It is a general rule that at least enough can be realized for the plant account and miscellaneous assets to offset any shrinkage sustained in the process of turning current assets into cash. [This rule would nearly always apply to a negotiated sale of the business to some reasonably interested buyer.] The working capital value behind a common stock can be readily computed. Consequently, by using this figure (i.e., net-net asset value) as the equivalent of "minimum liquidating value" we can discuss with some degree of confidence the actual relationship between the market price of a stock and the realizable value of the business.

Our definition of net nets is taken from Graham and Dodd's *Security Analysis*, but with a few twists. Graham and Dodd relied on a GAAP classified balance sheet to define current assets in order to ascertain if a common stock was a net net. We use our own judgment rather than GAAP classification to define current assets in order to decide what is a liquid, that is, a current asset.

While Graham and Dodd seem to have invented the idea of net nets, we use that idea with a number of modifications based on our discussions earlier in this chapter.

First, we are not interested in net nets unless the company is extremely well financed. A large quantity of current assets, especially if they consist of inventories, costs in excess of billings, or receivables from less than creditworthy customers, probably cannot help the common stock of a company that cannot meet its obligations to its creditors. Second, many current assets classified as current assets under GAAP are really fixed assets of the worst sort. Take department store merchandise inventories. If the department store is to be liquidated, merchandise inventories are indeed a current asset, convertible to cash within 12 months at prices that conceivably could be close to NAV, although much less than NAV may be realized if the merchandise is disposed of in a GOB (going out of business) sale. On the other hand, if the department store is a going concern, merchandise inventories are a fixed asset of the worst sort. The merchandise inventories have to be replaced, are hard to value, and are subject to markdowns, obsolescence, shrinkage, seasonality, and mislocation. The Toyota Industries portfolio of marketable securities seems to be much more of a current asset than department store merchandise inventories even though, for GAAP or IFRS purposes, Toyota Industries' marketable securities are not considered a current asset. Third, the Graham and Dodd formulation does not account for off-balance-sheet liabilities that may, or may not, be disclosed in footnotes, nor do Graham and Dodd take into account excessive expenses or losses. We capitalize such expenses or losses, and we add them to liabilities. Fourth, Graham and Dodd only seem to recognize partially that certain fixed assets, such as property, plant, and equipment, can sometimes create cash. For example, under Section 1231 of the U.S. Internal Revenue Code, the sale at a loss of such assets used in a trade or business, usually gives rise to an ordinary loss for income tax purposes. In that case, a corporation may be able to apply the loss first to reduce current year taxes and any excess loss might be used to get quickie cash refunds from the IRS with regard to taxes paid in the prior two years.

The identification of net nets does not appear to be that difficult. Cheung Kong Holdings, The Wharf Holdings, and Capital Southwest, discussed earlier in this chapter, are clear examples of Graham and Dodd net nets. The toughest problem by far, is to identify managements and control groups of these net nets who are both able and conscious of the interests of outside, passive, minority investors. This problem notwithstanding, the investor using a fundamental finance approach can obtain large margins of safety by restricting his purchases to issues selling at steep discounts from readily ascertainable NAVs from highly creditworthy issuers with good prospects for increasing NAV in the future at rates of 10 percent per annum or larger.

When all is said and done, however, we owe an enormous debt of gratitude to Graham and Dodd for introducing the concept of net nets.

OPMI INVESTING IN COMPANIES WITH GROWING NAVS

Historically NAVs of reasonably managed companies with reasonably strong finances grow year by year, almost continuously. This can be seen in [Table 6.10](#), which shows the changes in book values for the Standard & Poor's 500 stock index during the 18 years ended December 31, 2012. The book values increased in 16 of the 18 years failing to do so only in 2002, an aftermath of the bursting of the dotcom bubble; and 2008, an aftermath of the onset of the Great Recession. During the 18 years period book value per share increased from 206 to 661, or at a rate of 6.7 percent per annum compounded before adding back dividends paid.

Table 6.10 SPX Index Historical Price to Book Value Ratio

Date	Last Price	Book Value	P/B Ratio
12/31/2012	1,426	661	2.2×
12/31/2011	1,258	616	2.0×
12/31/2010	1,258	575	2.2×
12/31/2009	1,115	514	2.2×
12/31/2008	903	451	2.0×
12/31/2007	1,468	530	2.8×
12/31/2006	1,418	495	2.9×
12/31/2005	1,248	448	2.8×
12/31/2004	1,212	417	2.9×
12/31/2003	1,112	360	3.1×
12/31/2002	880	317	2.8×
12/31/2001	1,148	335	3.4×
12/31/2000	1,320	310	4.3×
12/31/1999	1,469	290	5.1×
12/31/1998	1,229	265	4.6×
12/31/1997	970	250	3.9×
12/31/1996	741	230	3.2×
12/31/1995	616	215	2.9×
12/31/1994	459	206	2.2×

One of the things the increase in book value connotes is that for those companies that remained creditworthy, their borrowing capacity in 2012 was greater than it had been in earlier years. This comports with our thesis, both for corporations and governments, that in the aggregate debt is never repaid. Rather it is refinanced and expanded by economic entities that remain creditworthy.

Book value in the aggregate seems to be a good surrogate for NAV, but they are not the same thing in our view. For many of the companies making up the S&P 500 Index, high book value for assets such as surplus automobile assembly plants or obsolescent steel mills represent overhead costs that are unlikely to ever contribute to operating earnings or cash flows (though as Section 1231 assets they may give the owner of the assets favorable income tax attributes). When we focus on NAV, we restrict ourselves to readily ascertainable NAVs of companies that are well financed.

Determining what is readily ascertainable is not rocket science. Readily ascertainable asset values exist where corporate assets consists of cash, marketable securities, performing loans, income-producing real estate, and other income-producing assets such as infrastructure and many power generators such as hydroelectric facilities. Also included are intangible assets, which appear to have a ready market for sale such as assets under management (AUM) of mutual fund management companies.

In our analysis, we try to invest in the common stocks of well-financed companies with readily ascertainable NAVs selling at discounts from such NAVs of at least 20 percent. Further, we restrict such investments to companies that we believe, after thorough analysis, have good prospects to be able to grow those NAVs by not less than 10 percent per annum compounded over the next three to five years.

Obviously, the vast majority of companies in the S&P 500 Index would not qualify for inclusion in our list of recommended NAV common stocks. As [Table 6.10](#) shows, the average common stock in the S&P 500 Index was selling at 2.2 times book value (and was probably not as well financed as our recommended common stocks). In contrast, we will not pay more than 0.8 times readily ascertainable NAV for our recommended issues.

At June 30, 2012, a list of recommended NAV common stocks would include the issues contained in [Table 6.11](#).

Table 6.11 List of Recommended NAV Common Stocks Based on Our Criteria

Common Stock Issue	Recent Price	NAV Latest Available Date 6/30/2012	Price Discount from NAV
Brookfield Asset Management (US)	32.96	41.81	21.2%
Capital Southwest (US)	102.81	145.35	29.3%
Cheung Kong Holdings (HK)	94.14	136.55	31.1%
Forest City Enterprises (US)	14.60	21.06	30.7%
Henderson Land (HK)	42.37	80.55	47.4%
Hopewell Holdings (HK)	20.70	36.50	43.3%
Investor A/B (SWE)	131.70	204.18	35.5%
Lai Sun Garment (HK)	0.81	4.31	81.2%
Toyota Industries (Japan)	1,462.00	2,349.00	37.8%
Wharf Holdings (HK)	42.4	74.18	42.8%
Wheelock & Co (HK)	28.98	67.12	56.8%

Assuming growth in NAV over the next three to five years of 10 percent per annum, including dividends, the probabilities of losing money over this long term don't seem great. Wheelock offers a good example. Over the next three- and five-year periods, Wheelock's December 31, 2011, NAV given a 10 percent annual growth would increase to \$80.29 per share and \$97.15 per share respectively. To have a market loss on Wheelock Common the NAV discount would have to become greater than 64 percent after three years and 70 percent after five years. This could happen but seems unlikely. Wheelock's probabilities of growing earnings and cash flow over the next three to five years seem to be very good. If Wheelock is not to achieve the 10 percent growth bogey, it may well be because of increased capitalization rates being applied to income-producing real estate as part of the independent appraisals mandated by IFRS accounting. Incidentally, in the five years to December 31, 2011, the average annual growth in Wheelock's NAV after adding back dividends was 20.4 percent.

Obviously not all the companies listed in [Table 6.11](#) are going to achieve 10 percent compound annual growth over the next three to five years. We are just not that competent as analysts to be that accurate about so many predictions. However, it is interesting to see how the actual portfolio fared in the five years through 2011. Only three common stocks, which were selling at NAV discounts five years previously—Capital Southwest, Investor A/B, and Toyota Industries—failed to grow NAV by as much as 10 percent compounded and one, Toyota Industries, actually suffered a small decline in NAV. Marketwise, the price of two of the common stocks was up, and only Toyota Industries common stock market price declined, and that only by 5 percent or so. The one issue in [Table 6.11](#) that suffered material price depression in the market after 2007 was Forest City common. Prior to the 2008–2009 meltdown, Forest City common was selling at a very large premium over NAV; it was also not well financed. Neither of these factors seems to exist for Forest City in 2012.

While investing in readily ascertainable NAVs at a discount may provide OPMIs with considerable downside protections over the long term, it seems to offer no protection against short-term market risk, that is, fluctuations in security prices. Further, while investing in readily ascertainable NAVs at a discount may be a good way to enjoy a reasonable absolute return, it in no way assures an OPMI that favorable relative returns will be achieved compared with other investment approaches. In addition since the approach does nothing to guard against near-term market risk, it probably is dangerous to finance an NAV portfolio largely with borrowed money. After all in our recommended approach we emphasize a factor—growth in NAV—that is almost completely ignored by most market participants.

Growth in NAV is the prime measure of investment results used in certain parts of the securities markets, such as investment companies. Berkshire Hathaway, Brookfield Asset Management and White Mountains Insurance. But growth in NAV never seems to be a factor for the vast majority of OPMIs who seem focused on the primacy of the income account, short-termism, and top-down analysis.

We think our approach is particularly useful for passive market participants who have long-term outlooks and needs, and who don't finance largely with borrowings. Such investors include pension funds and individuals saving for retirement.

In following our approach, U.S. taxpayers might want to avoid those companies, which for U.S. tax purposes are deemed to be passive foreign investment companies (PFICs). PFIC taxes are onerous. Among other things U.S. taxpayers holding PFIC securities are subject to ordinary income taxes each year on unrealized appreciation. Such a tax has the three worst elements of a tax, to wit, the tax rate is at the optimum; the taxpayer has no control over when the tax comes due; and the event, unrealized appreciation, which gives rise to the tax does not give rise to the cash with which to pay the tax. In [Table 6.11](#) only Investor A/B, Lai Sun Garment and Toyota Industries appear to be PFICs.

For almost all OPMIs, it seems very hard to try to beat the market consistently by trying to beat the market. The activity is just too competitive. Rather it seems to us a more rational approach is to be value conscious rather than outlook conscious. Acquire the common stocks of well-capitalized companies at deep discounts from readily ascertainable NAVs. We feel comfortable insofar as at least 50 percent of a common stock portfolio consists of safe and cheap equities such as those listed in [Table 6.11](#), that is, the company enjoys a super strong financial position; the common stock is priced at, at least a 20 percent discount from readily ascertainable NAV; disclosures are comprehensive; the common stock is traded in well regulated markets, and the prospects appear good that over the next three to seven years, NAV will grow by not less than 10 percent compounded annually after adding dividends.

Once acquired these securities could be held indefinitely unless the security becomes grossly overpriced; the business seems to have suffered a permanent impairment (e.g., using company cash for an injudicious acquisition); or for portfolio considerations, such as required redemptions of ownership interests.

While not on our radar screen, perhaps over the long term, one or more of our portfolio companies are to be subject to resource conversion activity. For example, if there were to be a change of control through a new party acquiring common stock, there seems a probability that OPMIs would realize a premium (maybe a substantial premium) over NAV. Given a strong financial position and a deep discount from NAV, many insiders would consider going private, including a leveraged buyout (LBO) at a premium over market but probably a discount from NAV.

SUMMARY

Net asset value or NAV, unlike reported accounting earnings, seems to play little or no role in influencing day-to-day stock market prices. This is probably the principal reason why nearly all writers about financial accounting and security analysis have denigrated the importance of NAV as a tool of valuation, emphasizing instead a primacy of earnings. In this chapter, we detail reasons why we think attention to NAV should be useful for creditors and investors. We believe that in almost all analysis outside of the day-to-day stock-trading environment, NAV is a highly useful tool of analysis for a variety of purposes, including as a comprehensive measure of the wealth-creation capability of a business, as an appraisal of companies and managements as operators, investors, and financiers and as one measure of the resources and liquidity available to a business. NAV analysis can be extremely useful. We offer examples where growth in NAV can be an almost assured source of profit or an absence of loss for the fundamental finance investor and how NAV analysis can be used to see whether market pricing is way ahead of corporate fundamentals. We redefine the concept of net nets and in doing so highlight the importance of understanding what accounting numbers mean rather than what they are. Finally, we offer the OPMI a primer on investing in companies with growing NAVs.

* This chapter contains original material and parts of the chapter are based on material contained in Chapter 12 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (© 2006 by Martin J. Whitman and Martin Shubik) and ideas contained in the 1998 3Q, 4Q, 1999 1Q, 2003 3Q, and 2006 1Q letters to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ Benjamin Graham, David L. Dodd, and Sidney Cottle, *Security Analysis: Principles and Technique* (New York: McGraw-Hill, 1962).

² American Institute of Certified Public Accountants, *Accounting Principles*, Section 1022.04.

³ Herman W. Bevis, *Corporate Financial Reporting in a Competitive Economy* (New York: Macmillan, 1965).

⁴ George D. McCarthy and Robert E. Healy, *Valuing a Company: Practices and Procedures* (New York: Ronald Press, 1971).

⁵ Graham, Dodd, and Cottle, *Security Analysis*. See especially pp. 551–552.

⁶ Op. Cit., p. 132.

⁷ Op. Cit., p. 50.

⁸ Op. Cit., pp. 103–4.

⁹ *Return on investment* is usually defined as net income as a percentage of net worth and funded debt. *Return on equity* is usually defined as net income as a percentage of capital stock and surplus; sometimes when preferred stocks are outstanding, ROE is defined as net income as a percentage of net worth (with the net worth account including preferred stock, common stock and surplus).

¹⁰ *Surplus surplus* is a name we think, but are not sure, was invented by the New York State superintendent of insurance around 1969.

¹¹ Since the new number of shares relative to the old number is 1.315, the proportion of old shares at a book value of \$1 is $1/1.315$ or 76 percent, while the proportion of new shares priced at \$5.25 is 24 percent. The new book value per share is calculated as $(0.76 \times \$1 + 0.24 \times \$5.25)$, or \$2.02.

CHAPTER 7

Creditworthiness*

Creditworthiness from the Borrowing Entity Point of View

Capital Structure

Capital Structure from the Corporate Perspective

Factors Affecting Capital Structure

Conservative Capital Structures

Summary

For those who hold or invest in junior securities—from unsecured obligations through common stocks—and for those interested in the general economy, it is hard not to overemphasize the importance of creditworthiness. Put simply, if an economic entity—corporate, government or individual—cannot be made creditworthy, sooner or later it will have to restructure its obligations or liquidate.

There are three tests of creditworthiness:

1. Does the fair value of assets exceed the amount of claims embedded in actual liabilities? A balance sheet test.
2. Is there sufficient cash flow from operations and/or the sale of assets to allow the economic entity to meet its required debt service obligations as they become due? A cash flow (or income) test.
3. Does the economic entity have access to capital markets, which it can use to meet cash shortfalls? A liquidity test.

Few realize that in order to remain solvent—that is, creditworthy—an economic entity does not necessarily have to pass all three tests. Passing only one will often do. Paul Krugman, an eminent economist, wrote frequently in 2008 and 2009 about “zombie banks.” A zombie bank was one where the contractual obligations embedded in liabilities exceeded the fair value of assets. The fair value of liabilities was not, and could not be, the market value of obligations. Rather it was the dollar amount of claims that would have to be paid to all obligees, mostly depositors, both principal and interest. Krugman seems to have missed the point that these banks were not insolvent since they seemed to have the ability, however marginal, to meet their obligations as they became due. Also the banks had access to capital markets even as capital from the private sector froze up. The government could, and did, provide funds through its TARP program.

As is pointed out in Chapter 25 on Hertz Global Holdings, a highly leveraged company, barely profitable, remained more or less creditworthy only because the company had access to capital markets at all times subsequent to its 2005 change of ownership.

From the point of view of outside passive minority investors (OPMIs), we do not believe that most long-term common stock investing makes much sense unless the corporation embodies

unquestioned creditworthiness. Thus our recommended investments are in the common stocks of companies that enjoy exceptional financial strength, sound operations and/or assets, and trustworthy management or control groups. Call it overkill, but it is also quite comfortable to be invested in the common stocks of companies whose solvency is not close to ever being in question. Besides the insurance provided to the OPMI holding junior securities, creditworthiness also affords management options to be opportunistic; that is, use it as an asset in resource conversion activities to create wealth.

The only OPMIs we think can safely ignore creditworthiness are secured creditors, where the value of the security pledged far exceeds the amounts of the claims against it, and where loan covenants prevent a dilution of that protection.

As bottom-up investors following a fundamental finance approach, we have always focused on creditworthiness much more than almost any other person or group writing about security analysis or economics. Thus, for us there exists the strict discipline of not investing in any common stock knowingly unless the issuing company enjoys a strong financial position. This is in contrast to almost all conventional market participants who view businesses as strict going concerns and as a result emphasize a primacy of the income account; that is, principal weight in an equity valuation goes to earnings from operations and/or cash flow from operations. Almost all other OPMIs seem to denigrate the importance of strong financial positions.

This tendency to downplay the importance of creditworthiness is prevalent also on the macro level, probably even more so than for bottom-up investors. This attitude has been well summarized by former Vice President Dick Cheney, who was quoted as saying, "Deficits don't matter." For the vast majority of people, the important economics statistics are gross domestic product, employment and unemployment levels, corporate earnings, and productivity increases. Creditworthiness is pretty much ignored.

CREDITWORTHINESS FROM THE BORROWING ENTITY POINT OF VIEW

Based, as always, upon a bottom-up, fundamental finance approach to analysis, our view of what is happening in the U.S. economy seems to be quite different from the views held by politicians and academics. Central to the economic debate and discussion throughout 2011 has been the question of the solvency of the United States government. Declaring the U.S. bankrupt is now in fashion and has been used to justify investment decisions and to sell investment strategies and products. Still, the question of U.S. solvency, or the solvency of any economic entity whether a government, a corporation or an individual, is worth considering.

The true test of solvency is the creditworthiness of the economic entity, not the amount of debt that it owes. The amount of debt is important, and we discuss corporate capital structure and its determination later in the chapter. Debt however, is only one element in determining creditworthiness. In fact, creditworthiness or credit capacity, is a function of three factors:

1. The amount of debt
2. The terms of debt
3. The productivity in the use of proceeds arising out of the borrowings

The first factor is how much indebtedness is being incurred via balance of payments deficits, other governmental borrowing, corporate borrowings, and borrowings by consumers. Of itself, increasing indebtedness is not a huge problem, provided the use of funds created by the borrowing is productive, that is, creates wealth. Insofar as the use of proceeds does not result in wealth creation, or it creates only modest increases in wealth—that is, there exists a negative multiplier, or a modest multiplier—the borrowing entity, sooner or later, has to face diminished creditworthiness (except if the entity can sell assets on a massive scale).

The third factor—productivity or growth—seems by far the most important of the three

factors for the U.S. government. Historically, certain U.S. government uses of proceeds have been unbelievably productive, such as the Homestead Act of 1862 and the Servicemen's Readjustment Act of 1944 (the G.I. Bill of Rights).

While it is relatively easy to measure the productivity of use of proceeds at the corporate level—profits and/or growth in net asset values—it tends to be much harder (although not impossible) to measure productivity where the expenditures are made by a government not motivated primarily by seeking profits.

EXAMPLE

The U.S. government did run budget surpluses in the mid to late 1990s, as a direct result of decades of debt-financed, productive spending. Much of the credit for that performance seems attributable to the dot-com bubble, made possible by the widespread adoption of the Internet and the vast electrical and telecommunications infrastructure of the United States. Various newly minted billionaires paid huge amounts of capital gain taxes, and the tax base was broadened, as a new industry created demand for highly skilled, and mostly well paid, workers. Much of the growth in high tech during that time seems to have been triggered, in part, by the initial public offering (IPO) Boom and, in part, by defense cutbacks, which compelled smart engineers and nerds to get involved in attractive start-ups, rather than taking jobs with Lockheed Martin and General Dynamics. The speculative excesses of the 1990s seem to have contributed much permanent good to the economy with the development of extremely able, extremely productive, high-tech industries. All of this occurred while causing huge harm to passive market participants who speculated in dotcoms and did not sell their commitments in time.

As investors using a fundamental finance approach, we measure the creditworthiness of a company by looking at the entity's ability to have and to create liquidity either:

1. From surplus cash
2. From other assets readily convertible into cash, such as a portfolio of blue-chip corporate common stocks and bonds whose resale is not restricted, Class A income-producing real estate, and so on (quality of

assets)¹

3. By an ability to generate surplus cash from operations (quality and quantity of resources)
4. By an ability to access capital markets when needed:
 - a. Ability to borrow or
 - b. Ability to market new issues of equity securities²
5. By the relative absence of liabilities either on balance sheet, off balance sheet, in the footnotes to the financial statements, or out there in the world (quality of resources)

Since most conventional approaches view creditworthiness only through the lens of how much debt the economic entity has in relation to the some measure of the value of its assets (the balance sheet test), a discussion of capital structure from the corporate point of view will be instructive.

CAPITAL STRUCTURE

Modern financial theorists, and Graham and Dodd fundamentalists, for that matter, look at corporate capital structure exclusively from the point of view of what impact a capital structure is likely to have on the market price of a corporation's common stock. In fundamental finance we view capital structure as something that arises out of a process that involves meeting the needs and desires of a multiplicity of constituencies, including various creditors, regulators, rating agencies, managements and other control groups, outside passive minority investors (OPMIs), and the company itself. Below we enumerate factors that ought to be weighted in the determination of capital structure.

Adopting the modern capital theory (MCT) approach to appropriate capital structure, which theorizes about the probable impacts of capital structure on OPMI market prices, is akin to studying the solar system by assuming the sun revolves around the earth. In this analogy, the earth is an OPMI, and it is given an importance in the solar system completely out of sync with readily observable reality. Although this perspective might be fine for an OPMI, it is inappropriate for an investor following a fundamental finance approach or anyone wishing to take a corporate perspective on capital structure.

CAPITAL STRUCTURE FROM THE CORPORATE PERSPECTIVE

An understanding of the specific factors affecting capital structure requires knowledge of the several conceptual differences that arise from taking a corporate perspective rather than the traditional efficient-market or Graham and Dodd views.

Substantive Consolidation

An underlying assumption found in MCT and in Graham and Dodd is that there is a substantive consolidation between the interests of the OPMI and corporate feasibility.³ These theories hold

that the exclusive way to determine the value of a corporation is to find the total market value of all its outstanding equity securities and add to this the amount of corporate obligations outstanding, either as measured by claim amount or market value.

From the value-investing perspective, there is no substantive consolidation. Furthermore, OPMI desires frequently conflict with corporate feasibility. There are three obvious cases in which such conflicts are common:

1. The short-run OPMI desire for maximum reported earnings even if it means higher corporate income-tax bills than would otherwise exist
2. The tendency of OPMI's to have very short-run agendas, even though long-term expensive projects might enhance corporate values materially
3. The OPMI desire for cash dividends or cash distributions in the form of common stock buybacks even when corporations might have much better uses for cash retained for corporate uses

Accessing Equity Markets

Corporate feasibility and OPMI stock price are essentially equivalent when the corporation is seeking access to capital markets to raise funds through the sale of new issues of equity, especially common stock equity. Here, though, the close relationship is measured by whether the corporation can access capital markets at all, not by the per-share price the corporation will receive for the sale of a new issue of common stock that does not pay a cash dividend. In this instance, per-share price can have a more or less dilutive effect on common shares. The price has no real effect, however, on corporate feasibility.

Financing with Retained Earnings

For most corporations, accessing equity markets for new funds is a sometime thing, rather capricious in its doability and almost always very expensive in terms of overall underwriting costs. Consequently, the vast majority of public corporations fill their equity needs through retaining earnings. Only a small percentage of earnings, or none at all, are paid out to shareholders as cash dividends. The indicated percentage payout for Standard & Poor's (S&P) 500 Index in August 2011 was 41.6 percent.

There are important exceptions, though, to financing with retained earnings. The most notable one has been the electric utility industry. From 1945 through the late 1970s, most companies in the industry were experiencing average annual growth in the demand for electric kilowatts of about 7 percent per annum. Massive capital expenditures were needed to produce \$1 of annual revenue (estimated at about \$5 of capital expenditures for every \$1 of annual revenue). Normal capitalization consisted of 50 to 60 percent long-term mortgage debt, 10 percent preferred stock, and 30 to 40 percent equity. Equity had to be increased relatively regularly and in relatively major doses. The industry ensured for itself access to equity markets by paying out as dividends 70 to 80 percent of earnings, which then made their securities attractive to income investors. Furthermore, per-share dividends were increased modestly as often as once a year. Every 18 to 24 months, however, the companies marketed new issues of common stock to obtain requisite funds to finance massive capital expenditures while keeping debt-to-stock ratios in line with mortgage debt covenants and with industry custom and usage. Thus, appeal to a constituency that wanted regular and increasing dividends ensured that utilities would have access to a capital source they needed.

There remain a number of companies in other industries that follow the electric utility model of paying out dividends representing a high percentage of their earnings and then periodically marketing new issues of common stocks. Real estate investment trusts (REITs) and many finance companies follow such policies. Indeed, REITs are required to pay out at least 90 percent of net

income as dividends if they are to remain REITs and enjoy a flow-through income-tax status, where the REIT itself is not subject to income tax because otherwise taxable income is paid out to shareholders.

The concept of high dividends combined with frequent access to equity markets that is implicit in the efficient market hypothesis (EMH) and Graham and Dodd views of capital structures, however, is not common.

Dividend Policy

Benjamin Graham and David Dodd, in discussing dividend policy, focused on substantive consolidation. According to Graham and Dodd and the EMH, a company that enjoys a high return on equity (ROE) should retain earnings, and a company with a low ROE should pay out its earnings as dividends when its shareholders could earn more than the company could by reinvesting the net proceeds from dividend payments. For fundamental finance investors, dividends are to be viewed as a residual use of cash, something to be paid to shareholders only after a company's needs to retain cash are met. The company's reasonable needs come first. The company's needs are of three types: to acquire assets, to pay or otherwise satisfy creditors, and to provide a margin of safety against an unpredictable future. Many high-ROE companies have little or no need to retain cash and can afford high dividend payouts (e.g., money-management companies). Many low-ROE companies had better retain most cash generated from operations if they are to survive (e.g., integrated aluminum producers, discount retailers, and meatpackers). ROE should not be a test for a firm's ability to pay dividends.

Constituency Stakes in Corporate Feasibility

There seems to be a view that the common stockholder community has a consuming interest in corporate feasibility but that other constituencies (notably creditors) do not. Creditors, it is postulated, just want to receive back principal plus interest even if it bankrupts the company, but such a view is unrealistic. The vast majority of creditors have continuing relationships with the companies to whom they lend, so they are interested in refinancing maturing debt and/or continuing to ship goods or rent properties. Everyone—not just common shareholders—has a stake in corporate feasibility.

Constituency Conflicts with Corporate Feasibility

Every constituency, including OPMI shareholders, also has conflicts with corporate feasibility. Each wants things from companies that detract from feasibility. Holders of common shares want dividends, creditors want cash payments and tough covenants, and managements want huge compensation packages.

As is stated in previous chapters, each constituency related to a corporation has objectives concerning the company that combine communities of interest and conflicts of interest. There is usually nothing special about OPMIs compared with other constituencies except that most OPMIs need not have a permanent or semipermanent stake in the company and that once an OPMI owns common stock, the OPMI has no further obligation to do things for the company. Thus, OPMIs are not smarter or better informed than other constituencies, and OPMIs do not have an exclusive interest in corporate feasibility. Two things, however, do distinguish many OPMIs from other constituencies: they have no particular need for a cash return, and they have no need for elements of control. All other constituencies tend to be intelligent, their markets tend toward efficiency, and they each seek to maximize their financial interests. (These characteristics are not exclusive to OPMI shareholders; they are shared with creditors, regulators, rating agencies, managements, and control shareholders.)

Actually, other things being equal, OPMIs are often a lot less knowledgeable than others who have to rely exclusively on the performance of the business for a cash bailout and who cannot, unlike OPMIs, look to a sale to a market for a cash bailout. Put simply, a life insurance company making a long-term private-placement unsecured loan to a company is probably a lot more knowledgeable about the company than are the OPMIs trading common stock on the New York Stock Exchange (NYSE). First, the insurance company can do due-diligence research beyond the public record. Second, the insurance company does not waste time and energy analyzing factors that probably have no relationship to specific corporate values (e.g., the level of interest rates or of the gross domestic product [GDP], dividend policy, or technical market considerations). Offsetting this somewhat is the likelihood that the insurance company knows that the more senior the issue and the shorter its maturity, the less the corporate analysis that needs or ought to be undertaken.

Capitalization in Resource Conversion

Capitalization becomes extremely important in resource conversion activities. The resource conversion topics that are discussed in this book—mergers and acquisitions (M&As), leveraged buyouts (LBOs) or management buyouts (MBOs), initial public offerings (IPOs), and restructuring troubled companies—all involve major recapitalizations. For example, LBO analysis involves first a determination of an enterprise's value and dynamics and then an examination of the cost of money and an application of a new capitalization. Exactly the same economic procedures are followed when reorganizing troubled companies, either out of court or in Chapter 11. In the case of LBOs, however, the capitalization is leveraged up, in that debt is substituted for equity. In the reorganization of troubled companies, the capitalization is leveraged down, in that equity, debt with soft terms, or both are substituted for senior debt and other onerous obligations.

An easy way of remembering the above is to recall that in the reorganization of troubled companies, recapitalization tends to make sick companies healthy, whereas in LBOs, recapitalization tends to make healthy companies sick.

FACTORS AFFECTING CAPITAL STRUCTURE

In all financial activities, there is a tendency toward efficiency: All participants in a process attempt to do as well as they reasonably can under the circumstances, given their agendas and the agendas of other participants. This certainly holds true for capitalization. Creditors comport, regarding this tendency toward efficiency, in the same way as do OPMIs, although the primary item on a creditor's agenda might be the avoidance of a money default whereas the primary item on an agenda of an OPMI involved in short-term trading would be the maximization of total return.

Efficient corporate capital structure, the financing layer cake of the corporation, takes into account myriad factors, including the following:

- The composition and characteristics of the assets that offset the capitalization
- The needs and desires of the several classes of creditors
- The needs and desires of regulators
- The needs and desires of rating agencies
- The needs, desires, and proclivities of management and control groups
- Custom and usage
- The professional advice of investment bankers, attorneys, and

accountants

- The desires of OPMIs and OPMI representatives

Investors using a bottom-up approach should appreciate all of these.

The Composition and Characteristics of Assets

Asset management is mainly a function of liability management; by contrast, liability management is mainly a function of asset management.

What amount and types of liabilities that ought to be part of a corporate capitalization has to be very much a function of having assets employed in the business in ways that produce sufficient resources to service the liabilities. There are two sources from which liabilities can normally be serviced: internal cash flow obtained either from employment of assets or sale of assets, and access to capital markets for new financings (this is usually a function of the business's having earnings—the ability to create wealth).

The overall insurance industry provides a good case study of how the character and amount of liabilities influence—indeed, govern—the management of asset portfolios. Insurance companies' assets consist essentially of investments in debt instruments and other securities. Liabilities consist essentially of estimated obligations to policyholders in the form of policyholder reserves (life companies) and reserve for losses and unearned premiums (property and casualty companies).

In life companies, the policyholder reserve is a very long term, reasonably certain, and actuarially determined (on a year-to-year basis) liability. Given this type of liability, life companies' investment assets usually consist mainly of long-term privately placed loans. By contrast, property and casualty companies are subject to dramatic and relatively unpredictable (on a year-to-year basis) demands for cash payouts arising from, say, hurricanes or earthquakes. Thus, property and casualty companies' investment portfolios consist largely of marketable securities, salable to meet the businesses' sudden needs for cash to satisfy claims. Furthermore, property and casualty companies generally fund the dollar amount of their liabilities by investing in credit instruments (debt securities). Common stock investments are only a small portion of property and casualty company portfolios, limited to dollar amounts no greater than the firm's statutory surplus. Statutory surplus is net worth computed in accordance with insurance regulations, rather than Generally Accepted Accounting Principles (GAAP). Each net worth figure, statutory or GAAP, is reconcilable with the other.

The analysis of capital structure is very much a function of where you sit. In some contexts, consolidated financial statements are useful, but in other, parent and subsidiary financial statements are key. From the perspective of common stockholders in a holding company, the consolidated financial statements present a useful indication of what the overall results and overall resources are for the company. From the point of view of a lender to the parent holding company, however, parent-company financials are crucial to determining creditworthiness. The parent company directly owns only the common stock of its subsidiaries, not the specific assets of the subsidiaries, even though these subsidiary assets are reflected in the consolidated financial statements.

To service their debts, most parent companies have to receive cash from their subsidiaries. There are essentially four ways in which this cash can be received: dividends, home-office charges, tax treaties, and sales by the parent of the common stock owned. Sales of common stock of the subsidiaries may be impractical. If the holding company is in a regulated industry (e.g., insurance or banking), cash payments by the subsidiaries to the parent may be vigorously proscribed. If the subsidiary—say, a finance company or department store chain—borrows money, then the loan covenant may limit payments to the parent. Thus, a parent company that may appear, on a consolidated basis, to be quite solid really may not be creditworthy at all.

The Needs and Desires of the Several Classes of

Creditors

Creditors as a group are probably the most important force determining what corporate capital structures will be. By and large, creditors are intelligent, and many are relatively knowledgeable about the businesses they finance. Put otherwise, they operate in a market with strong tendencies toward efficiency.

Credit markets seem to be much bigger than equity markets and can be deemed to include all payables owed by businesses including accrued expenses, accounts payable, rents payable, taxes payable, and borrowing from banks, other institutions, and the public. Creditors are often a lot more knowledgeable about the business in which they invest than are OPMIs. They are much more serious analysts than are OPMIs. This is understandable because most creditors have to look to corporations for their bailouts. It is actual business performance that will generate cash to pay them principal and interest. It is quite understandable that creditors tend to have strong views about the amount of money they will let a company borrow. By contrast, most OPMIs look to a sale to a stock market for their bailout. Many, as for example those with a technical chartist approach, could not care less about the business. Their knowledge of it can be as restricted as knowing what the stock ticker symbol is.

Creditors of corporations, when financing their own businesses, often have far greater access to borrowings to finance their assets (portfolios of loans to corporations) than would be the case if their assets were common stocks. Portfolios consisting of performing loans generate contractually assured cash to service their obligations, but common stocks usually do not. Market price volatility is considerably less for performing loans than for common stocks.

Predictable cash return on an asset has an importance independent of total return. An asset holder cannot expect to service obligations existing in most capital structures with unrealized appreciation; service has to be made in cash.

Intelligent creditors usually base investment decisions much more on reasonable worst-case assumptions than on base-case assumptions. As knowledgeable and analysis-oriented as creditors are about corporate values, though, they are not immune from making bad decisions. This is probably true because throughout U.S. history, forecasts of cash and earnings flows have been notoriously unreliable. Witness commercial bank lending to less-developed countries (LDCs) in the 1970s, energy lending before the oil bubble burst in the early 1980s, commercial real estate lending prior to 1986, and savings and loans' unacceptable interest rate risk and then credit risk in the 1980s and residential mortgage lending before 2007. Still, their understanding of corporate values tends to be much better than is that of the typical OPMI—bankers need to know how to read, but OPMIs do not!

The Needs and Desires of Regulators

Corporate capital structure is partially determined by well-informed analytic regulators who have as an agenda seeing that corporate capital structures are not too risky—that there is capital adequacy. These include bank regulators, insurance regulators, the Small Business Administration (SBA), and securities industries regulators, especially those working under the amended Investment Act of 1940 and also the Financial Industry Regulatory Authority (FINRA).

The Needs and Desires of Rating Agencies

An investment-grade imprimatur is essential for many companies operating in certain industries or seeking access to public markets for new issues of debt securities. Agencies providing investment ratings include Moody's Investors Service, Standard & Poor's Rating Services, Fitch Investors Service, Duff & Phelps Credit Rating Company, and A.M. Best Company. Corporate managements are very much aware of how capital structure affects the opinions of these agencies.

Creditors, regulators, and rating agencies tend to be efficient (and are probably smarter than most OPMIs). Most corporate loans are performing loans, and most corporations remain solvent.

This remains generally true despite the rating agencies' ineptitude before 2007, which contributed importantly to the meltdown after 2007 and to the Great Recession of 2008–2010.

The Needs, Desires, and Proclivities of Managements and Control Groups

Once it is observed that managements and control groups have multiple agendas that combine communities of interest and conflicts of interest with various of their constituencies, disparate factors affect managements' and control groups' influence on what an appropriate capitalization will be. Few managements are likely to conclude that the appropriate capitalization is that structure which will maximize the trading price of the OPMI common stock.

Custom and Usage

Custom is one of the strongest determinants of capital structure. Industry capital structures tend toward uniformity as the various providers of capital adopt common standards or norms. For example, historically, electric utilities have often been financed 50 to 60 percent with publicly held mortgage debt, 10 percent with preferred stock, and 30 to 40 percent with common stock and surplus.

In the LBO arena, senior secured lenders will lend approximately four to five times operating income (minus the excess of capital expenditures over depreciation plus a working capital facility) to finance a deal. Sometimes subordinated debentures, preferred stock held by the sellers or others, or both are available, though nowadays, almost always some meaningful common stock investment is made by the purchasers. The purchase price for the business might be 7 to 12 times the above-mentioned operating income.

Similar custom-and-usage ratios exist for finance companies, hotels, banks, cable companies, insurance holding companies, airlines, and others. Good investors become familiar with these ratios industry by industry.

Most custom-and-usage capitalizations are the most efficient way to capitalize companies, but this is not always true. Take department store and discount-store capital structures. Despite the general economic prosperity of the 1990s, a plethora of department store and discount store chains (Federated Department Stores, Macy's, Caldor, Kmart, Wards, Bradlees, Zayre) have had to reorganize their capital structure either out of court or in Chapter 11. The main reason was too much credit granted from three sources—financial institutions, trade creditors, and landlords.

The Professional Advice of Investment Bankers, Attorneys, and Accountants

Such fee-based advisors as investment bankers, attorneys, and accountants are important influences in determining corporate capital structure. Investment bankers tend to have great expertise in structuring the terms of securities so as to sell the securities in private placement and OPMI markets. Attorneys are key in dealing with securities questions as they effect the terms to be included in securities issues. GAAP is the province of accountants while both attorneys and accountants deal with income tax issues.

The Needs and Desires of Outside Passive Minority

Investors and Their Representatives

The OPMI market is the only constituency addressed by Graham and Dodd fundamentalism and proponents of the EMH in their discussions of capital structure and dividend policy. Indeed, the emphasis is even narrower because the focus is almost exclusively on estimated near-term impacts on OPMI market prices.

This emphasis seems misplaced. It has validity when the company itself and control shareholders are seeking access to capital markets to sell common stock to an OPMI market. This is an occasional occurrence, and the interests of the company itself revolve around being able to market common stock at all rather than around the price at which common can be marketed (an OPMI interest).

It is not that OPMI interests are ignored in determining a capital structure, but that those needs are tempered by requirements of other constituencies. In terms of capitalization, it is a good rule of thumb that satisfying creditor requirements is a lot more important than meeting OPMI desires in structuring a capitalization.

Risk is a word that should not be used without an adjective in front of it. Just because a common stock might have a lot of market risk (i.e., a plunge in OPMI market price) and a company might have a lot of investment risk (i.e., the business is unlikely to survive as a going concern) does not mean that adequately secured lenders to the corporation are taking any credit risk at all. Creditors can be confident that the loan will remain a performing loan or that in a reorganization, they will receive a value of principal amount plus interest and interest on interest. General risk really does not exist.

CONSERVATIVE CAPITAL STRUCTURES

In practice, many corporations operate with conservative capitalizations that provide an insurance policy for holders of junior securities and the corporation itself. In addition, trade creditors and public bondholders are not made nervous. The cost of doing this is a lower ROE (and perhaps stock price) than would otherwise be the case in buoyant periods when the business is prospering. If you pay to insure your house, however, and it does not burn down, that does not mean the expenditure for insurance was wasted.

Conservatively capitalized and well-managed companies are also more likely candidates for hostile takeovers. Raiders must rely solely on publicly available information; therefore they see good management and a strong balance sheet as insurance against a bad purchase. Not surprisingly, increasing corporate leverage is a standard tactic used by corporation managements to thwart takeovers.

Should OPMIs acquire the common stocks of companies with conservative capitalizations? Presumably, such common stocks will sell at lower prices, have greater potential for appreciation if they are to become leveraged in the future, and are more likely targets for takeovers. In addition, such investments would be more conservative because if operations are not as profitable as expected, there should be less downside.

On the other hand, there are offsets to make an OPMI want more leverage. If the company is unleveraged, the OPMI, as an investor, is not as likely to capture as much of the upside. The OPMI might also be in bed with managements or control groups who do not need access to stock markets and who do not care about the stock price in the short run. Investors on margin might not be able to wait an indefinite period of time for a return; or if they change their mind and need to cash out in the short run, they may do so without appreciation. Professional money managers who are primarily asset allocators and are evaluated on the basis of short-run performance might not want to take this kind of risk.

There is no universal answer to the question of whether to buy the stocks of leveraged or unleveraged companies. It depends on who you are and what you know. If you are a conventional asset allocator who does not know too much about finance or companies, then you might be better

off taking the more conventional approach to choosing your portfolio. On the other hand, if you read all the literature, understand individual companies and industries, and can appreciate the nuances of capital structure, then you might be better off going the underleveraged investment route. If you believe in the precepts of value investing, however, conservative capitalizations become highly desirable for OPMIs.

SUMMARY

If an economic entity—corporate, government, or individual—cannot be made creditworthy, sooner or later it will have to restructure its obligations or liquidate. There are three tests of creditworthiness: a balance sheet test, a cash flow or income test, and a liquidity test. Few seem to realize that in order to remain solvent, that is, creditworthy, an economic entity does not necessarily have to pass all three tests. Ignorance of this simple fact was evident in market commentary about both financial institution and sovereign discussions of solvency in the wake of the 2008–2009 crisis. Focus on the absolute or relative levels of debt is misguided since creditworthiness is a function of the amount of debt, the terms of the debt, and most importantly, the productivity of the use of proceeds from the borrowing. Investors using a fundamental finance approach, should measure the creditworthiness of a company by looking at the entity's ability to have and to create liquidity either: from surplus cash, from other assets readily convertible into cash, by an ability to generate surplus cash from operations, by an ability to access capital markets, and by the relative absence of liabilities. We provide a primer on capital structure from the corporate point of view to debunk the substantive consolidation view of capital structure that is prevalent in Graham and Dodd and modern capital theory.

* This chapter contains original material, and parts of the chapter are based on material contained in Chapter 7 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman), and ideas contained in the 2007 3Q, 2009 3Q, 2011 3Q letters to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ We discuss the quality of assets and how useful GAAP is in the appraisal of asset quality in Chapter 6 on net asset values.

² We discuss access to capital markets on a super-attractive basis in Chapter 25 on the economics of private equity leveraged buyouts.

³ Corporate feasibility is a concept that originates in the bankruptcy code in the context of a court approving a plan of reorganization (POR). A court will not approve a POR if it makes the debtor unfeasible; i.e. if its implementation will likely lead the debtor to seek another reorganization in the future.

CHAPTER 8

What Matters Is Investment Risk¹

There Is No General Risk—Only Specific Risk

The Components of Investment Risk

Successful People Avoid Investment Risk

Methods to Avoid Investment Risk

Safe and Cheap Investing and Minimizing Investment Risk

Summary

On pages 440 and 441 of the 1988 edition of *Graham and Dodd's Security Analysis* there is this remarkable statement:

*Clearly, the bond contract is inherently unattractive. In exchange for limited rights to share in future earning power, the bondholder obtains a prior claim on cash generated by the borrower and a definite promise of repayment at a stated date. Profitable growth will bring confidence to the investor but no material increase in return. The deterioration of profitability, however, will bring both anxiety and a downward market valuation of the issue.*²

Why would a downward deterioration in profitability not bring even greater anxiety and even greater downward market valuation to the holders of that company's common stock issue? As a matter of fact, if the bond is adequately secured or otherwise well covenanted, no money defaults might occur, and bondholders would feel no anxiety about holding the debt instrument *regardless* of market price. Sophisticated bondholders would probably conclude that they were incapable of predicting bond prices in OPMI markets for lower-rated issues to begin with; most people involved with value investing would certainly so conclude.

Graham and Dodd were probably right that there is a large amount of *market* risk for outside passive minority investors (OPMIs) in holding the bonds of debtors experiencing deteriorating profitability. It seems obvious, however, that great investment opportunities are created when *market* risk is ignored and *investment* risk is examined and guarded against. Assuming good covenant protections, is the bond form not inherently attractive when purchases occur after a downward market valuation caused by anxiety and a deterioration in profitability? Were investors unwilling to ignore *market* risk, they would miss opportunities to acquire debt instruments that seem utterly devoid of *investment* risk (e.g., the GMAC senior unsecured debentures in 2009 selling at a yield to maturity of around 50 percent). The investment analysis of the GMAC Debentures revolved around the fact that it would have been utterly unreasonable to conclude that these issues were being acquired at prices that represented a market bottom or even anything close to a market bottom, because the OPMI consensus, which could have proved right, was that the near-term outlooks were horrible and that GMAC, as an operation, was in deep trouble.

THERE IS NO GENERAL RISK—ONLY SPECIFIC RISK

In fundamental finance, the word *risk* is always modified by an adjective. There is no general risk. There is market risk, investment risk, interest rate risk, inflation risk, failure to match maturities risk, securities fraud risk, excessive promoters' compensation risk, and so on.

In value analysis, the tendency is to guard against *investment* risk, the prospect that things will go wrong for the business in which the activist has invested or in the securities issued by that business. *Market* risk, the prospect for price fluctuations in OPMI markets, is usually ignored. Put otherwise, the value analyst, in examining the risks in an investment, worries about permanent impairments of capital but not about unrealized market losses or a reduction in the amount of unrealized market profits.

The analysis of Kmart Debentures and Kmart Trade Claims (together, Kmart Credits) at the end of 1995 serves as a good example of the difference between *investment* risk and *market* risk. In late 1995, it seemed impossible to predict whether Kmart would seek reorganization under Chapter 11 of the U.S. bankruptcy code. It seemed a certainty that if Chapter 11 relief were sought, interest payments would stop and there would be no 18 percent yield-to-maturity. Further, the probability seemed to be that Kmart Credits would sell in the OPMI market at dollar prices well below the existing prices of around \$74, if for no other reason than that the holders of debentures relying on interest income, which would no longer be paid, would dump their holdings by immediate sale into the OPMI market. Thus, Kmart Credits seemed to carry a high degree of *market* risk.

Despite the existence of *market* risk, however, Kmart Credits seemed to carry little or no *investment* risk. If Kmart did not file in Chapter 11, Kmart Credits would continue to be performing loans, affording a yield-to-maturity 700 to 900 basis points above comparable credits. Furthermore, it appeared that if Kmart were to file for Chapter 11 relief, the company would be readily reorganizable, and since Kmart Credits were, in effect, the most senior issue of Kmart, the holders of Kmart Credits seemed bound to receive, in a Chapter 11 reorganization, a value in new Kmart securities of not less than 100—more likely 100-plus accrued post-Chapter 11 interest.

The previous analysis is in sharp contrast to what Graham and Dodd recommended as the theoretically correct procedure for bond investment in an approach focused on *market* risk rather than on *investment* risk. Graham and Dodd stated, on page 310 of the 1962 edition of *Security Analysis*, that “safety is measured not by specific lien or other contractual rights, but by the ability of the issuer to meet all its obligations,” a valid statement if one is focused on *market* risk rather than *investment* risk. On page 313, they went on to say that “the theoretically correct procedure for bond investment, therefore, is first to select a company meeting every test of strength and soundness, and then to purchase its *highest-yielding* obligation,”³ which would usually mean its junior rather than its first-lien bonds. In value investing, there might be some merit to buying the junior issue *only if* the analyst were in a position to determine that a creditworthy company would continue to remain creditworthy until after the bond owned matured. Almost no one is that good at predicting future corporate outlooks. Moreover, many—if not most—companies issue junior debt and preferred obligations (i.e., mezzanine securities) because of senior lender requirements that the businesses have expanded borrowing bases. Put otherwise, if these companies were so creditworthy to begin with, they might never have issued mezzanine securities in the first place.

Fundamental finance investors involved in credit analysis are covenant driven, the exact opposite of Graham and Dodd investors.

EXAMPLE

From 1992 to 1997, Eljer Industries Secured Bank Debt represented a good example of the importance of covenants. Eljer Bank Debt was a performing loan

secured by virtually all the assets of Eljer and its subsidiaries. A principal subsidiary of Eljer, U.S. Brass, had filed for Chapter 11 relief, however, and it remained theoretically possible that a huge amount of product liability claims would be perfected against Eljer. If so, those claims would become unsecured obligations, junior to Eljer Bank Debt. Overall coverage for Eljer obligations could have become quite weak; furthermore, there might even have been some *market* risk in holding Eljer Bank Debt. Given its senior secured position, however, it was hard to figure out how the Eljer Bank Debt would not be made whole, no matter what course the subsidiary's Chapter 11 took.

THE COMPONENTS OF INVESTMENT RISK

The result of the previous discussion is that for analytical purposes *investment* risk for a security has three components:

1. Quality of the issuer
2. Terms of the issue
3. Price of the issue

The analysis of the GMAC credits focused on all of these. GMAC appeared to be readily reorganizable (quality of the issuer), in the event of a money default the credits were the most senior GMAC issue (terms of the issue), and they could be bought at prices that provided an adequate margin of safety and total return (price of the issue).

When the focus is on quality of the issuer and terms of the issue only, as is a basic precept of academic finance, a risk-to-reward ratio comes into existence. For academic finance, the higher the quality of the issuer and the more senior the terms of the issue, the less risk of loss the investor is taking. Also, the higher the quality of the issuer and the more senior the terms of the issue, the less the rewards are likely to be for the investor, thus the risk-to-reward ratio.

For academic finance, the price of the issue as it trades in OPMI markets reflects a universal price equilibrium; that is, it is the correct price for all purposes and all participants. Insofar as the price of the issue is too high or too low, however, no risk-to-reward ratio exists; it cannot exist. Suppose the price is too low. That means that the issue carries a reduced risk of loss and an enhanced potential for reward. In value investing, there usually is no risk-to-reward ratio simply because price of the issue becomes so important that it outweighs the risk-to-reward equation that appears to be valid insofar as an analysis is based on an assumption of the existence of a price equilibrium, so that the only factors to weigh are quality of the issuer and the terms of the issue.

SUCCESSFUL PEOPLE AVOID INVESTMENT RISK

In the book *The Great Risk Shift* (Oxford University Press, 2006), Jacob S. Hacker, a political science professor at Yale University, discusses how in recent years various risks—job risk, family stability risk, retirement risk, and health care risk—have been shifted increasingly from corporations and governments onto the backs of individuals. The *raison d'être* for the great risk shift is to foster the creation of an ownership society where the beneficiaries of, say, pension plans and health plans take the risks that go with ownership by being responsible for investing funds with no guarantees of minimum returns. What the proponents of this type of ownership risk fail to recognize is that the most successful owners don't take risks. They lay off the risks onto someone else. Put simply, the vast majority of great individual fortunes built in this country, especially by Wall Streeters and corporate executives, were not built by people who took *investment risks*. Rather, the secret to building a great fortune is to avoid, as completely as possible, the taking of any *investment risk*. In terms of understanding corporate finance, economists have it all wrong when they say, "There is no free lunch." Rather, the more appropriate comment ought to be "Somebody has to pay for lunch—and it isn't going to be me."

As we have discussed, *investment risk* consists of factors peculiar to a business itself or to the securities issued by that business. *Investment risk* is a risk separate and apart from *market risk*. *Market risk* involves fluctuations in the prices of securities and other readily tradable assets. A directory of those in the financial community who build great fortunes by avoiding *investment risk* includes the following:

- **Corporate executives who receive stock options or restricted stock.** If the common stock appreciates, the executive builds a substantial net worth. If the common stock does not appreciate, the executive loses nothing; indeed, the executive may obtain new options at a lower strike price or new restricted common stock.
- **Members of the plaintiffs' bar who bring class action lawsuits in order to earn contingency fees.** The expenses involved in financing such lawsuits are minimal, and it is seldom that plaintiffs' attorneys ever incur costs for sanctions or for paying a defendant's costs and fees. The fee awards obtained tend to be huge upon settlement of such lawsuits or, less frequently, upon obtaining a favorable verdict for the plaintiff after trial.
- **Initial public offering (IPO) underwriters and sales personnel.** If you run a promising private company and desire to go public, you will find that many potential underwriters will compete for your business. However, as a general rule they won't compete on price. The price will be a 7 percent gross spread plus expenses. Thus, on a \$10 IPO, the gross spread will be \$0.70 per share. In contrast, to buy a \$10 stock in a secondary market like the New York Stock Exchange, a customer can negotiate a commission rate of, say, \$0.02 to \$0.05 per share.
- **Bankruptcy professionals—lawyers and investment bankers.** Chapter 11 is now set up so that bankruptcy professionals have to be paid in cash, on a pay-as-you-go basis (with only minor holdbacks); such payments are given a super-priority so that these professionals very rarely have any credit risk at all. Attorneys' fees billed at over \$1,000 per hour and investment banking fees of over \$300,000 per month (plus success fees) are not uncommon.

- **Money managers, mutual fund managers, private equity and hedge fund managers.** Normal fees might range from 1 percent of assets under management (AUM) to 2 percent of AUM plus 20 percent of annual realized or unrealized capital gains (after a bogey of, say, 6 percent paid or accrued to limited partners). These fees are paid to entities that receive the cash fees without incurring any credit risk in business entities that have few physical assets and very little necessary overhead. Most hedge funds are limited partnerships where the money manager is the general partner (GP) and outside passive minority investors (OPMIs) are the limited partners (LPs). A limited partnership has been waggishly described as a business association where at the beginning the GP brings experience and the LPs bring money. At the end of the business association, the GP has the money and the LPs have the experience.
- **Venture capitalists.** These people finance a portfolio of start-ups, and then are able to realize astronomical prices on some of the portfolio companies when there occurs, as it always seems to do from time to time, an IPO speculative boom.
- **Real estate entrepreneurs, especially investment builders.** Two keys to making fortunes in large-scale real estate projects are the availability of long-term, fixed interest rate, nonrecourse financing and income tax shelter.

METHODS TO AVOID INVESTMENT RISK

As an OPMI, it seems impossible to avoid *investment* risk altogether. The methods by which OPMIs can attempt to alleviate *investment* risk are:

- **Buy cheap** (price of the issue). Warren Buffett, the chairman of Berkshire Hathaway, describes his investment technique as trying to buy good companies at reasonable prices. Buffett, however, is a control investor, and while a reasonable price standard has worked remarkably well for Berkshire Hathaway, that standard is not good enough for OPMIs. OPMIs have to try to buy at bargain prices (i.e., cheap). The definition of *cheap* in acquiring common stocks in the vast majority of cases is to acquire issues at prices that reflect substantial discounts from readily ascertainable net asset values (NAVs), and such NAV is likely to increase by not less than 10 percent per year. Readily ascertainable NAVs means that most OPMI common stock portfolios will to a large extent be concentrated in financial institutions and companies involved with income-producing real estate. Control investors can afford to pay up versus OPMIs, because they are in a position to undertake financial engineering and to cause management changes. OPMIs pretty much have to leave companies as-is, and therefore place particular efforts into buying into well-managed businesses with stable, but clearly superior,

managements. In investing in distressed debt, too, the OPMI investor has to buy cheap. For the authors there are two rules of thumb in 2012: if the analysis indicates the probabilities are that a loan will be a performing loan, the minimum return sought is a 15 percent yield to maturity or yield to an event. Coupled with this is the requirement that if the loan does not remain performing and participates in a reorganization, the loss to the investor should be minimal. If it seems likely that the performing loan will default, the distress investor participating in a reorganization ought to look for an internal rate of return (IRR) at least of 30 percent.

- **Buy equity interests only in high-quality businesses or well-positioned debt instruments** (quality of the issuer or terms of the issue). One reasonable rule for OPMI is to not knowingly acquire the common stock of any company unless that company enjoys a super-strong financial position. If a company does not enjoy strong finances, be a creditor owning well-covenanted debt instruments. Also try as an OPMI to buy into reasonably well-managed companies. Any relationships between OPMI and corporate managements combine communities of interests and conflicts of interest. Diligent OPMI try to restrict themselves to situations where the communities of interest seem to outweigh the conflicts of interest. Restrict common stock investments to companies whose businesses are understandable to the portfolio manager and where there exists full documentary disclosure, including audited financial statements. In distress investing, the creditor has only contract rights. These contract rights ought to be strong enough to preclude or at least discourage management overreaching.
- **Ignore market risk** (price of the issue). Fluctuations in market prices are mostly a random walk, with changes in market prices not in any way a measure of long-term *investment* risk or investment potential. It is as Benjamin Graham used to say: “In the short run the market is a voting machine. In the long run the market is a weighing machine.” Most competent control investors—again Warren Buffett—pretty much ignore market risk also, in that little or no weight is given to daily, or even annual, marking to market for portfolio holdings.
- **If dealing in equities, buy growth but don’t pay for it** (quality of the issuer). In the financial community, *growth* is a misused word. Most market participants do not mean growth, but rather mean generally recognized growth. Insofar as growth receives general recognition, a market participant has to pay up. Cheung Kong Holdings, Wheelock & Company, and Brookfield Asset Management appear to be growth companies. None of these issues seem to enjoy general recognition as having growth potential in mid 2012.
- **It is usually a good idea to be a buy-and-hold investor** (quality of the issuer, terms of the issue, price of the issue). Although an entry point into a common stock is a bargain price, one can continue to hold a security where the portfolio manager believes that the business has reasonable prospects that it can over the long run increase annual NAV by a double-digit number, and where the portfolio manager does not

believe he or she made a mistake. Mistakes are measured by beliefs that there has occurred a permanent impairment in underlying value or financial position. Sell if there is a belief that the security is grossly overpriced. Also sell for portfolio considerations—that is, where there are massive enough redemptions of funds under management so that liquidity is threatened. Most sales in most well-run portfolios will occur because the portfolio companies are taken over. Investing in distressed credits, however, involves having some idea of a termination date except for call features. A call feature gives the issuer the right to redeem a debt obligation before maturity, usually at either the principal amount or at a relatively small premium. If a loan is to remain a performing loan, the instrument will contain payment schedules and a maturity date. If the distressed credit is to participate in a reorganization, there will be an estimated reorganization date; and if the debtor is to be liquidated, there will be an estimated winding-up date.

SAFE AND CHEAP INVESTING AND MINIMIZING INVESTMENT RISK

The standards used to minimize *investment* risk limit the selection of attractive securities. Adherence to the *safe and cheap* approach⁴ results in missing many investment opportunities where securities are attractively priced by standards other than those used by value investors. In following the approach, an investor, whether activist or an OPMI, will forgo many equity investments regardless of price if they do not meet all essential conditions for safety.

Conditions for an issuer to be safe include:

1. Strong financial position:
 - a. Relative absence of liabilities
 - i. On-balance-sheet
 - ii. Off-balance-sheet
 - iii. Out there in the world
 - b. Valuable assets (cash or near cash)
 - c. Free cash flows from operations
2. Reasonably well managed
3. Understandable business, which always means comprehensive disclosures and audited financial statements.

EXAMPLE

An emphasis on financial position could prevent one from investing:

- In airline equities because of a belief that the industry is dangerously financed (an example of on-balance-sheet liabilities) and would be even if re-equipment programs

were modified.

- In integrated steel and aluminum companies; in many electric utilities, because they may be encumbered with inordinately large capital expenditures requirements (an example of encumbrances that are not disclosed in accounting statements).
- In labor-intensive companies with large pension-plan obligations (an example of off-balance-sheet liabilities that are disclosed in financial-statement footnotes).

This does not mean that at certain prices such securities are not very attractive investments for many. They just do not happen to be attractive for us.

Under the safe and cheap approach, securities of issuers controlled by those believed to be predators should be avoided, regardless of price, by both activists and outsiders. The securities avoided are both equities and debt instruments. Significant clues as to whom the predators might be are publicly available from documents filed with the SEC. Especially pertinent in these documents are disclosures about management remuneration, and transactions between the company and insiders. These disclosures are contained either in the annual-meeting proxy statement or in Part II of the 10-K Annual Report. Disclosures about “litigation” in Part I of the 10-K Annual Report, Part II of the 10-Q Quarterly Report and in footnotes to audited financial statements can also give valuable clues to the caliber of management and control groups. Disclosure of grievances by creditors or securities holders that culminate in lawsuits brought against companies and insiders should serve as warnings that a particular company may not be a satisfactory investment using an *investment* risk minimization approach.

Those using the approach restrict investments to situations where considerable knowledge about companies can be obtained. This is true for both control and non-control investors. While reliance on public information only is sufficient—or even more than sufficient for certain types of investments, such as investment companies registered under the Investment Act of 1940 and public utilities—in other areas required public information frequently provides insufficient data for making intelligent decisions, as is usually the case when a company is engaged primarily in mineral exploration activities.

There is a close correlation between the usefulness of financial accounting and the usefulness of public disclosures as tools for making investment decisions. As accounting becomes more reliable, so do required public disclosures.

Most important, since the control and non-control groups value using the same standards, there tend to be clear conflicts of interest between insiders and outsiders. Insiders sometimes will create additional values for themselves by forcing out outsiders via the corporation’s proxy machinery that they control, by short-form mergers, or by the use of coercive tender offers. Force-outs sometimes can be at extremely low prices, because the insiders, by their actions (or lack of actions), have contributed to the depression of stock prices.

This conflict of interest presents a realistic threat that limits the appeal of a number of equity securities that would otherwise seem attractive using our approach. Although attempted force-outs at prices we would consider unconscionably low are relatively infrequent, they do happen.

EXAMPLE*

Wilmington Trust had three core businesses: (1) regional banking (primarily commercial and retail banking in the mid-Atlantic region); (2) wealth advisory (wealth preservation, transfer and estate planning services for high net worth individuals); and (3) corporate client services (asset administration and

management, trustee and agency services for institutional clients). Wilmington also owned 80 percent of value equity manager Cramer Rosenthal McGlynn and 40 percent of growth manager Roxbury.

The company came under financial pressure in the wake of the 2008–2009 credit crisis owing to problems in its construction and mortgage loan books. Anticipating credit issues and the need for shoring up its capital base in Q4 2008 the company had issued preferred stock along with warrants and a small amount of common stock. In May 2010 Wilmington had hired an outside consultancy to review its loan book and to assist it with a full-scope regulatory exam slated to begin in late June. By September 2010, Wilmington appeared to have adequate liquidity at the holding company level and a modest amount of excess capital at the regulated banking subsidiary. Wilmington seemed to be adequately capitalized for regulatory purposes even under stress-case scenarios of heavy losses in the loan book. A sum-of-the-parts analysis suggested a range of value for the common stock from \$8 to \$14.

By October 2010 market rumors suggested that Wilmington had been contacting buyers, including a number of Canadian banks and was separately looking to raise capital from private investors to shore up its balance sheet. On November 1, 2010, Wilmington announced that it had agreed to sell itself to M&T Bank of Buffalo in a stock deal that valued Wilmington Common at \$3.84, translating to a 46 percent *discount* to the previous week's market price.

The deal valuation apparently surprised many observers who suggested that M&T was able to steal Wilmington. M&T management maintained that the deal was struck at *pro forma* tangible book value (*pro forma* for anticipated credit losses). Underestimating

“regulatory risk” was one main failure of the analysis. In the early days following the Credit Crisis, the Feds seemed to care little about shareholders’ interests or economic values but wanted to protect depositors at all costs. When the Feds told the management team of a regulated entity to do the deal, managements like Wilmington’s had no alternative. In this case, M&T offer appeared to ascribe no value to Wilmington’s non-banking business and affiliated investment management businesses.

* This example was extracted from a report titled: “Takeunder Case Study—Wilmington Trust,” by Curtis Jensen, Third Avenue Management, August 2012.

SUMMARY

In fundamental finance, the word *risk* is always modified by an adjective. There is no general risk. There is market risk, investment risk, interest rate risk, inflation risk, failure to match maturities risk, securities fraud risk, excessive promoters’ compensation risk, and so on. In value analysis, the tendency is to guard against *investment* risk, the prospect that things will go wrong for the business in which the activist has invested or in the securities issued by that business. *Market* risk, the prospect for price fluctuations in OPMI markets, is usually ignored. Great investment opportunities are created when *market* risk is ignored and *investment* risk is examined and guarded against. For analytical purposes investment risk for a security is a function of three factors: the quality of the issuer, the terms of the issue, and the price of the issue. Even though it is almost impossible to avoid investment risk altogether as an OPMI, we provide a list of methods by which an OPMI can attempt to alleviate this type of risk.

¹ This chapter contains original material, and parts of the chapter are based on ideas contained in the 1999 4Q, 2003 4Q, 2006 2Q, 2007 2Q letters to shareholders.

² Benjamin Graham, David L. Dodd, Sidney Cottle, Roger F. Murray, and Frank E. Block, *Graham and Dodd’s Security Analysis, Fifth Edition*, (New York: McGraw-Hill, 1988).

³ emphasis added

⁴ The approach is discussed at length in Chapter 15.

CHAPTER 9

Shareholder Distributions from the Company Point of View*

Cash Dividends or Retained Earnings

Stock Dividends

Stock Repurchases

Distribution of Assets Other than Cash

Liquidation

Summary

A basic difference between us and other analysts, including Graham and Dodd, is that others believe an appropriate dividend policy is derived from looking at payout policies through the stockholder's, rather than the company's, point of view. It is our view that for most companies, the formulation of appropriate shareholder distribution policies requires that stockholder needs and desires be distinctly subservient to the needs of the corporation itself.

Others believe, at least by implication, that the price at which a stock sells, relative to a company's earnings and asset values, is somehow related to an appropriate payout policy. We, on the other hand, believe that dividend payouts must be regarded as a residual use of corporate cash and that company requirements for cash in other areas must have primacy.

CASH DIVIDENDS OR RETAINED EARNINGS

Dividend policy has to be dictated by company needs, both for funds for expansion and for maintaining a margin of safety. Furthermore, we think the price at which a common stock sells (except in special cases, of which public utilities are the prime example) should have little to do with a company's payout policy. The special case exception is a going concern company that knows it has to periodically obtain capital from the sale of new issues of common stock, and uses dividends to support the price of its stock so that it will be able to market shares publicly at a more assured price than otherwise.

Graham and Dodd, in support of this other view, write in *Security Analysis*:

The higher the average multiplier of earnings in the stock list, the greater the proportion of issues which presumably should retain all or nearly all of their profits. . . . For—presumably again—the rate of

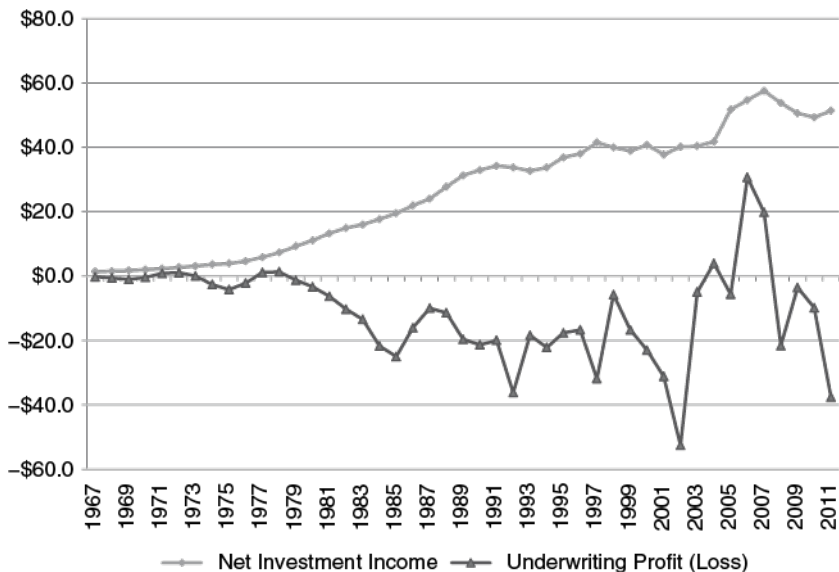
*return on reinvestment will substantially exceed, in a typical case, what the stockholder could earn on the same money received in dividends. A good corporate earnings picture and opportunities for capital expansion generally go together. Thus, the favorable business and stock market developments of the 1950's have greatly extended the field of companies for which, in theory at least, low dividends and high reinvestment would appear the best policy for stockholders. Carried to its logical conclusion, this analysis would suggest that nearly all really successful companies should follow a program of full reinvestment of profits, and that cash dividend should be paid only to the extent that opportunities for profitable expansion or diversification were not present.*¹

We question the Graham and Dodd analysis on three counts. First, the high price-earnings ratio or multiple seems wholly unrelated to the business's needs for cash. The underlying assumption Graham and Dodd appear to use here is that the market has been appraising the business's prospects accurately in the multiple it has assigned to the shares. There is no empirical evidence supporting such a view. Indeed, the only logical conclusion to draw is that companies should retain earnings when they have opportunities for profitable investment, regardless of the price of their common stock. Second, whether or not they have opportunities for profitable investment of the funds is not something that is going to be told to companies or their managements by the stock market appraisal of how their earnings are capitalized. Finally, distributing cash to stockholders has to compete with using the cash to reduce or defease liabilities.

The property and casualty insurance industry serves as an example of the use of retained earnings as an engine of compound growth when stocks generally sell at low multiples and steep discounts from net asset value.

As a rule of thumb, property and casualty insurers pay out as dividends about one half of their net investment income and reinvest the other half. These reinvested earnings, plus cash generated from increasing volume of insurance underwriting premiums (and when available, insurance underwriting profits), are used to purchase income-producing securities. Thus, though the underwriting performance of the industry from the mid-1970s on was poor (generally little better than break-even), net investment income increased steadily up until 2008. After 2008 net investment income stopped growing because the U.S. government pursued a policy of ultra-low interest rates. This steady increase in investment income—despite an erratic underwriting performance, is shown in the following figure, covering the years 1967 through 2011, prepared from data in Dowling & Partners.²

Figure 9.1 Net Investment Income and Underwriting Profit (Loss) for P&C Insurers, 1967–2011 in Billions



Assuming that a company has superior uses for cash to expand its productive asset base and that the company has only uncertain access to capital markets to sell new issues of common stock, it is always far more productive from a long-term point of view if a company retains cash rather than distributes it to shareholders. For growth companies, distributions of cash to shareholders can be a good use of cash, but it frequently is not the best use of cash. It was far more productive for IBM, Xerox, Intel, and Microsoft, in their early days, to plow back cash into the businesses than it would have been to distribute that cash to shareholders.

Insofar as the company does not have profitable use for the reinvestment of the funds and is financially strong enough to have a margin of safety, funds should be distributed to shareholders.

The characteristics of cash dividends are as follows:

- Dividends are mandatory; each stockholder is required to accept the cash payment.
- Dividends paid by qualified U.S. corporations are tax advantaged for noncorporate U.S. taxpayers. At the federal level, the dividends are subject to a 15 percent tax rate.
- For dividends, there is at least a 70 percent exclusion for stockholders that are qualified corporations.
- Many OPMI stockholders like dividends. Benjamin Graham and David Dodd were big fans of dividends.
- Dividend payments can improve access to capital markets, especially common-stock markets for those companies that need relatively regular access to outside equity financing. Companies that have needed relatively regular access to outside capital markets include electric utilities, finance companies, and real estate investment trusts.
- Shareholders receive cash without giving up any ownership interest.

From the corporation's point of view, it sometimes is important to have consistent, sound policies of (a) paying regular dividends and (b) increasing dividends periodically. This occurs when the market prices of the shares are determined primarily by the dividend return and when corporate capital requirements are far too huge to be financed either internally or by debt.

Consequently, new equity has to be marketed every few years. Thus, liberal dividend policies become an integral part of corporate financial policy for such companies. These companies are characterized by great operational stability, so that the type of investor attracted can depend on a steady dividend income continually covered by earnings. However, these corporate characteristics do not describe the vast majority of publicly held companies, and there is no reason for supposing that what might be an appropriate dividend policy for these companies is also applicable to others.

This is not to say that a corporation in its own interests and in its management and controlling stockholders' interests does not frequently find it desirable to maintain consistent and even liberal dividend policies. One reason an incumbent management might want to pay liberal dividends is that low dividend payouts may result in low stock market prices, with the consequence that the business becomes more susceptible to a raid. Higher dividends may protect a management's position. This may be especially true where corporate prudence would dictate that a dividend be reduced or eliminated, either of which action would tend to result in gross stockholder dissatisfaction.

Influential stockholders, including management, may infrequently have needs for the cash return income that comes from dividends. Sometimes, too, an increased dividend will result in an increased stock price that could be important to insiders (or to the company itself) intending to sell all or part of their holdings.

Occasionally, companies have no practical internal use for cash, especially if diversification and acquisitions would result in antitrust problems for those operating in relatively mature industries. However, it is our anecdotal observation that the vast majority of public companies are not only operations but also investment vehicles. Viewed as an investment vehicle, the company has incentives to retain cash rather than disburse it to shareholders.

A long-run, consistent dividend policy is frequently essential if a company is to obtain general recognition in the financial community as a high-quality issuer. Such recognition tends to result in better prices for a company's common stock over the long term, and may attract outside stockholders who are stable investors interested in income (insurance companies for example) rather than in-and-out traders or go-go speculators.

STOCK DIVIDENDS

There is a school of thought that asserts that there would be benefits to corporations and stockholders if corporations paying cash dividends would, as a consistent annual policy, also pay stock dividends to shareholders, the market value of which would be in an amount about equal to retained earnings for the year.

EXAMPLE

If XYZ stock sells at 20, earns \$2, and pays a cash dividend of \$1.20, many people recommend that the \$.80 of retained earnings be paid out in the form of a stock dividend—in this case 4 percent, or \$.80 divided by \$20. If the following year's retained earnings equal \$1.10 and the stock price is 34, the suggested stock dividend would be 3 percent.

Proponents of this policy believe it benefits shareholders. Shareholders receive on a tax-free basis new stock that, if they desire to do so, they can convert to cash by selling the shares received,

and they would be taxed at only capital gains rates rather than at dividend income rates. Because of the stock dividend policy, the corporation would have less need to raise cash dividends and consequently less need to seek new equity financing from its existing shareholders. Viewed in this light, there is something to be said for a policy of periodic stock dividends and less frequent subscription rights to shareholders, compared with the policy most public utilities employ—of raising the common cash dividend periodically to support the price of the stock, and then selling new shares to stockholders, often via subscription rights.

Although this may be so in the special case of utilities, the advantages of regular stock dividends in most situations most of the time seem highly limited. Even in the case of public utilities, the advantage of periodic stock dividends over periodic increases in the cash dividend rate may be limited. A utility's need for outside equity financing on a continuing basis tends to be so huge as to dwarf into insignificance the amount of cash that could be retained by paying stock dividends instead of periodically increasing the cash dividend. Stockholders and the utility are best served by the policy that results in the stock's selling at the most favorable price most consistently. Many commentators feel that periodic increases in the cash dividend have a more favorable market impact than regular stock dividends, but we do not know of any definitive studies on one or the other.

One small utility, Citizens Utilities, had in the 1950s and 1960s a two-issue common stock capitalization: an A stock, which paid a cash dividend; and a B stock, which paid only a stock dividend in a market value amount equal to the cash dividend on the A. The B is convertible into the A, but has virtually always sold at a premium over the A. Duplication of the Citizens Utilities capitalization would be impossible now, because Internal Revenue has slammed the barn door shut, so that for any stock issued now with Citizens Utilities B features, IRS holds that the stock dividend is the equivalent of a cash dividend. One of the three things that make a tax position unattractive is a taxable event—such as the distribution of a Citizens Utilities B stock dividend—where the event that gives rise to the tax does not also give rise to the cash with which to pay the tax.

It is rare to find U.S. companies paying regular stock dividends, especially among those that also pay cash dividends. Stock dividend policies do make some sense for companies that do not pay cash dividends but that do plow back cash: stock dividends give shareholders evidence, in the form of a salable stock certificate, that corporate progress is being made. Stock dividends also make some sense, however limited, for companies with a public utility type of dynamics, in which new equity will be publicly marketed on a regular, recurring, reasonably predictable basis. However, most companies pay, or intend to pay, regular cash dividends, and most do not have a public utility type of dynamics. Most companies seek outside equity financing on an irregular and highly unpredictable basis, if at all. For such companies, payments of stock dividends result in regular increases in the aggregate amount of cash paid out, with possibly little or no benefit to shareholders. This would not have been the case had the company raised the cash dividend rate, say, once every three years.

A simple example shows how a company that desires to maintain a regular rate can be locked into increasing cash outlays on a compounding basis if it also wants to pay regular stock dividends.

EXAMPLE

Assume Company XYZ's dividend rate is \$1 cash plus 5 percent stock, and there are 1 million shares outstanding. If this dividend situation is maintained, XYZ's annual cash dividend payout (in thousands) will be as shown in [Table 9.1](#).

The payment of stock dividends gives rise to a number of administrative headaches, too. There have to be

adjustments of past per-share figures on earnings, dividends, and book value, and of calculations in connection with antidilution provisions in convertibles and warrant instruments; stockholders have to be mailed new certificates, and there may be a tendency for XYZ's stockholder list to become burdened with large numbers of odd-lot shareholders, whom it is quite expensive to service with dividend and stockholder report mailings, relative to the market value of their investment. If we were advising XYZ, we would suggest to them that both the company and their shareholders would be better off if XYZ gave up the 5 percent annual stock dividend and instead increased the regular dividend rate by, say, 5 percent once every three years.

Table 9.1 Annual Increase in Cash Outlays for Cash Dividends Caused by a Stock Dividend Program

Year	Dividend Cash Expenditure	Annual Increase in Cash Outlays
Present	\$1,000	\$—
1	\$1,050	\$50
2	\$1,103	\$103
3	\$1,158	\$158
4	\$1,050	\$216
5	\$1,276	\$276
6	\$1,340	\$340
7	\$1,407	\$407
8	\$1,477	\$477
9	\$1,551	\$551
10	\$1,629	\$629

Stock dividends, too, pose administrative problems for stockholders, many of whom seem to believe that retaining stock dividends only results in their having more paper and more paperwork. Those who sell the shares received find that their equity in the company is diluted.

STOCK REPURCHASES

Both dividends and stock repurchases result in cash being distributed to the stockholder. Despite stigmas or hangups about liquidation, buying in common stocks in certain instances can be a viable alternative for companies with the requisite liquidity.

On an overall basis, buy-ins have the following relative advantages for stockholders:

- In the usual case, such receipts of cash are taxed only on a capital gains basis.
- On the part of the stockholder, the receipt of the cash usually is optional, rather than mandatory (as is the case with dividend receipts).
- Weak shareholders sell out, with possible favorable implications for future market prices.
- If, as is frequently the case, buy-ins are at a price below the value based on corporate reality, the per-share corporate reality value of the shares not bought in is enhanced.

There are advantages to corporations as well:

- Insofar as the common stock is dividend-paying and, as is usual, the company desires to maintain a dividend rate, cash requirements for future dividend payments are reduced.
- Earnings per share, book value per share, and corporate-reality value per share may be enhanced.
- A program can result in the elimination of all, or virtually all, public shareholders.
- Where the price of the stock can be a tool to be used by the company in, say, future acquisitions, buy-ins can result in a more favorable price for shares that remain outstanding than would otherwise be the case.

Buy-ins, of course, bring certain relative disadvantages to public shareholders:

- First and foremost, if the buy-ins are of massive size, investors may be forced out of a company altogether, at a price that may be very low compared with corporate reality, even though such a price could be at a substantial premium over market.
- Even if not forced out, they would find that the shares remaining after a buy-in may have only very limited marketability, since buy-ins are usually only a sometime, irregular source of cash to stockholders, whereas dividends can be counted on as a regular, continuing source of cash receipts. Companies buying in common, other than in privately negotiated transactions, are inherently in a conflicted position with public shareholders: the companies are buyers, and the public are sellers. And public stockholders understand dividends, but there is something remote and mysterious about buy-ins.

Buy-ins also bring certain other relative disadvantages to corporations, even to those that unquestionably have surplus cash and no better use of it than to repurchase shares selling at prices that are attractive relative to corporate reality:

- First, there are many legal strictures against buying in, whether by open-market purchase,³ by tender, or by use of the proxy machinery; there even can be difficulties when purchases are made in private transactions.
- Besides inherent conflicts with public shareholders, there also may be

conflicts with insiders who might want to purchase shares. And there may be appearances of payoffs to inside shareholders who desire to sell.

We stress that buy-ins are a legitimate use of corporate cash. As a practical matter, buy-ins are likely to remain a limited activity simply because for most corporations, no matter how attractively priced their managements think their stock is, share repurchases are impractical—the company lacks either the liquidity or the legal authority to repurchase or retire shares. In many cases, the companies will have expansion opportunities—such as Xerox and Texas Instruments had—which make share repurchase relatively unattractive. In other cases, laws prevent repurchases, as in the cases of electric utilities or commercial banks. In most cases, though, companies will lack enough cash or borrowing power to undertake meaningful buy-in programs. However, the buy-in program conducted by IBM Corporation that commenced in 1977 and has continued, gave buy-ins a new cachet and respectability that was lacking previously. IBM sought to acquire as many as 5 million of its own shares via a cash tender offer at \$280 per share; the corporation succeeded in acquiring 2,567,564 shares in that tender offer.

The repurchase of large amounts of publicly owned shares by companies, or the purchase of such shares by insiders, results in a company going private or *going dark*. For a going private all public shareholders are cashed out. This usually occurs in a cash-out merger situation. Not so for going dark, which can occur when the number of shareholders of record is below 300. The regulations meant to control going dark are embodied in part in Rule 13e-3 of the Securities Exchange Act. A going-dark transaction is one that has either a reasonable likelihood or the purpose of producing directly or indirectly the elimination of any SEC requirements that the company make disclosures to its equity holders.

DISTRIBUTION OF ASSETS OTHER THAN CASH

A company may be in a position to distribute assets other than cash to stockholders. Sometimes those assets distributed can be dividends for tax purposes and can encompass such things as portfolio securities (distributed by Standard Oil of Indiana from 1948 to 1963); chocolate inventories (by Rockwood Chocolate in the 1950s); and even whiskey (by Schenley Distillers during World War II). Such distributions are rare because of possible disadvantages to shareholders, since the dividend event that gave rise to the tax does not provide the cash with which to pay it.

For tax reasons, most distributions to shareholders that are in kind rather than in cash are tax-sheltered distributions. The most famous of such distributions was that of DuPont's holdings in General Motors Company common stock during 1962, 1964, and 1965. By act of Congress, these distributions were exempted from tax as a dividend.

The income tax code has numerous provisions that allow shareholders to receive distributions in kind and in cash on a tax-sheltered basis. Such provisions are in the tax code sections dealing with spinoffs, split-offs, split-ups, redemptions, reorganizations, and liquidations. Discussion of these is beyond the purview of this book.

LIQUIDATION

A word on liquidation seems appropriate, however. The common definition of corporate liquidation concerns the payout in cash and/or in kind of an amount greater than the company's accumulated retained earnings. In some circles, liquidation seems to bear a stigma as something

that is nonproductive. Our view as to what liquidation is and what it means tends to be different. To us, any payment by a corporation to its shareholders—even quarterly dividends—is a form of liquidation. Whether or not permanent capital other than retained earnings is invaded is an accounting question, not an economic one. Certainly, no stigma of nonproductivity ought to attach to stockholder distributions of any sort, in any amount, as long as the company distributing can afford to do so and believes the distribution is a good enough use of cash. In fact, the vast majority of companies are unable to make any material-sized distribution now, not because they lack adequate retained earnings, but rather because they lack adequate liquidity. In most cases, the companies are prevented from distributing more than a portion of annual earnings to shareholders, both by common sense and by restrictions in their various loan agreements. In the broadest and most meaningful sense, we do not believe there is any such thing as liquidation. Rather, there is only asset conversion—a conversion of assets to different uses and/or ownership, where much of the time they will be more productive.

SUMMARY

It is our view that for most companies, the formulation of appropriate shareholder distribution policies requires that stockholder needs and desires be distinctly subservient to the needs of the corporation itself. Furthermore, we think the price at which a common stock sells (except in special cases, of which public utilities are the prime example) should have little to do with a company's payout policy. We describe certain characteristics of cash dividends and explain why in certain circumstances having a liberal dividend policy may be beneficial either to the company or management and insiders. Finally, we discuss other forms of distributions including share repurchases, distribution of assets and liquidations.

* This chapter contains original material, and parts of the chapter are based on material contained in Chapter 15 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (©, 2006 by Martin J. Whitman and Martin Shubik). This material is reproduced with permission of John Wiley & Sons, Inc.

¹ Benjamin Graham, David L. Dodd, and Sidney Cottle, *Security Analysis: Principles and Technique* (New York: McGraw-Hill Book Company, 1962).

² Dowling & Partners, industry statistics, www.dowling.com

³ The principal stricture against open-market purchases is contained in Securities Exchange Act Regulation 13e-3. Most would-be corporate open-market repurchases abide by 13e-3 in order to avoid running into accusations of market manipulations that are violations of antifraud statutes, particularly Rule 10b-5.

CHAPTER 10

Roles of Cash Dividends in Security Analysis and Portfolio Management*

[The Three Conventional Theories](#)

[Cash Dividends as a Factor in Market Performance](#)

[The Placebo Effect of Cash Dividends](#)

[Cash Dividends and Portfolio Management](#)

[Cash Dividends and Legal Lists](#)

[Cash Dividends and Bailouts](#)

[The Goals of Securities Holders](#)

[Summary](#)

Cash dividends are money payments to corporate shareholders paid out of a company's accounting earned surplus, made in proportion to each shareholder's ownership interest in the class of stock receiving the dividend. Once the dividend is declared, the stockholder has no choice other than to take it. Control of the size and timing of the payout is with the company and not the outside stockholder.

As we pointed out in Chapter 3, it is unrealistic to view finance and investment problems as if there existed monolithic stockholders and monolithic corporations, or as if there were any necessary relationship between the value of a business and the price of its common stock. Yet, insofar as the three most widely accepted theories about the relationship of cash dividends to value and common stock prices are concerned, the underlying assumptions appear to be based on just such misperceptions. The three most widely accepted theories are those propounded by John Burr Williams, Modigliani and Miller, and Graham and Dodd.

It is important for investors relying on a fundamental finance approach to investing to understand the roles cash dividends play in security analysis, portfolio management, and corporate finance. We believe the real roles of cash dividends tend to be different from those postulated in traditional theories. For us, there are six principal roles of cash dividends:

1. Dividend levels and changes in dividends, up or down, seem likely to have impacts on stock market prices.
2. Cash dividends are important placebos for non-control investors insofar as such investors lack confidence in the merits of the equity securities they hold.
3. Dividends are crucial in portfolio management where prudent managers seek a positive cash-carry—that is, where they strive to have income from the holding of securities exceed interest expense (and

possibly dividend costs, too) incurred in connection with obligations or quasi-obligations assumed in connection with the portfolio being managed.

4. The receipt of dividend income may be a legal necessity for certain security holders, such as various fiduciaries.

5. Dividends paid to U.S. taxpaying shareholders by qualified U.S. corporations are tax advantaged as compared with comparable interest income paid by corporations. For federal income tax purposes, dividends received by individuals are subject to taxation at capital gains rates. Interest received is taxed at ordinary income tax rates. Qualified corporations receiving dividends from qualified corporations exclude at least 70 percent of the dividend received from any federal income tax whatsoever.

6. It is our view that for any investment to be attractive the investor has to perceive a bailout sooner or later, and dividends are one form of bailout.

In a rational world, no investment can be attractive unless there are prospects for a bailout. Bailouts can be of two types: in the first, control of a business can be obtained; in the second, there are prospects that the investment will become convertible into cash in whole or in part. Non-control investments can become convertible into cash because:

- The securities are marketable; they can be sold in the open market; in private transactions; pursuant to a cash tender offer; or pursuant to a cash-out merger or certain reverse splits.
- The minority investor can hope to exercise certain rights, such as rights of appraisal under state law; and/or
- The investor can look forward to the receipt of cash dividends.

We think it is important to distinguish between the significance of interest income to typical holders of senior securities and the significance of dividend income to common stockholders. The goals of common stockholders tend to be less well defined than are those of holders of credit instruments.

Two of the three theories—John Burr Williams's and Graham and Dodd's—appear to be compatible with our views, provided the underlying assumptions of each theory are modified to fit in with our ideas of economic and financial reality. The Modigliani and Miller theory, on the other hand, may be useful as a theoretical exercise; it does not appear to have any practical application and is indeed, misleading because it ignores completely the important concept of creditworthiness.

THE THREE CONVENTIONAL THEORIES

The first theory, propounded by John Burr Williams in a book entitled *The Theory of Investment Value*,¹ states that a common stock is worth the sum of all the dividends expected to be paid out on it in the future, each discounted to its present worth. The second theory, propounded by Franco Modigliani and Merton H. Miller in 1958,² in an article entitled "The Cost of Capital, Corporation Finance and the Theory of Investment," states in effect that as long as management is presumed to be acting in the best interests of the stockholders, retained earnings should be regarded as equivalent to a fully subscribed, preemptive issue of common stock, and therefore that dividend

payout is not material in the valuations of a common stock. The third theory is detailed in Chapter 35 of Graham and Dodd's *Security Analysis*,³ and states that in the case of the vast majority of companies, higher common stock prices will prevail when earnings are paid out as dividends rather than retained in a business. Graham and Dodd feel that the only exceptions to this rule are cases where a company's return on investments is unusually large, and where the company's stocks sell at high multiples of earnings and at huge premiums over book value.

The Williams theory might be of use in an ideal world, but it is of little help in a complex, wealth-creating economy such as ours. The Williams theory, undiluted, would only apply in a tax-free world where the universal *raison d'être* for owning common stocks was to receive dividends and the *raison d'être* of all corporate activities was to pay dividends to common stockholders.

The Williams theory, to be realistic, could be restated to posit that a common stock held by noncontrol stockholders is worth the sum of all the net after-tax cash expected to be realizable in the future from ownership of the common stock, with such net cash being realizable either from cash disbursements by the company (whether in the form of dividends or otherwise, such as liquidating in whole or in part), and from sources outside the company (whether they are stock purchasers or lenders willing to treat the common stock as collateral for borrowings by the shareholder). Such cash realizations would be discounted to reflect time factors and the probabilities of realizations as well as tax considerations and trading costs. Purely and simply, such a theory equates with our bailout views of investment value.

If one wanted to make the realistic assumption that the ultimate goal of all non-control investment is cash realization, then the Williams theory as we have modified it would fit in well with our perceptions of the real world. However, even that has to be modified. It would still not apply universally, since the ultimate goal of *all* investment is not cash realization. For many investors (for example, a corporation that has no intention of ever paying cash to its equity holders), the goal of its investment may not be cash realization, but wealth creation through control over the growth of unrealized investment values. Other investing entities may combine goals of ultimate cash realization and continued reinvestment.

Unlike the Williams approach to evaluating common stock, the Modigliani and Miller assumptions seem utterly unrealistic. There does not appear to be any basis in fact for assuming either that managements act in the best interests of stockholders or that stockholders have an absolute community of interests among themselves. The simple fact is that relationships among managements and stockholders of public companies are always combinations of communities of interest and conflicts of interest.

Managements frequently, even traditionally, pay lip service to the proposition that they work in the best interests of all stockholders, especially outside stockholders. Increased management salaries and perquisites are justified on the basis that stockholders' best interests are served by using such compensation devices to attract and hold highly motivated personnel.

Companies go private by buying out their stockholders at discounts from realizable values. This activity is justified on the basis that it is in the best interests of the stockholders to force them to take, in cash, a value that represents a premium over the prevailing stock market prices—even though the prices may reflect a thin market in which very few shares could be bought or sold without increasing or depressing stock market prices. This activity may in fact be working in the best interests of many of the outside stockholders, but certainly not all. The Modigliani and Miller view of the fiduciary management selflessly toiling for the ideal stockholder simply does not accurately describe how all managements of public companies think and operate. Nor does it accurately describe the objectives of the many different types of stockholders.

That managements do not tend to work primarily in the best interests of all stockholders has been pointed out by John K. Galbraith in his book *The New Industrial State*.⁴ Management itself collectively and individually constitutes a group that always has some conflict of interest with at least some outside stockholders. Other groups of whose interests the management is keenly aware (and whose interests are at least partially adverse to the interests of some of the stockholders) are other securities holders, such as institutional creditors, labor unions, suppliers, customers, and the staff of the company itself.

If there were any generalization to be made, it would be that management, in balancing the interests of the various groups they feel they have to serve, tends to work more in the best interests of those groups that bring the most benefits to the management. Activities in these directions,

though, are tempered by the need and sometimes the desire to guard the interests of other groups, especially those whom management has to constantly deal or negotiate with on a one-to-one basis. Conversely, there is a tendency to guard least the interests of those who are truly outsiders and passive, with whom management rarely, if ever, deals personally. The outside groups that managements of publicly owned corporations tend to view impersonally are the outside passive minority investors (OPMIs) and the Internal Revenue Service, among other tax-collection agencies.

Since managements have virtually no community of interests with tax collectors, there is no tendency to guard the interests of this group, except as required by law and in reaction to threats of audit or other investigatory activity. True, over and above the law, outside stockholders tend to receive better treatment than tax collectors, even though they may be more passive. Most managements do not view outside stockholders either as allies or as adversaries. And there are times when managements want what most outside stockholders want—for example, a high price for the company's common stock. But this convergence of interests may occur less frequently than many people suppose.

Probably the best indications that managements do not, on the most practical level, work in the best interests of stockholders can be found in the need for an elaborate legal structure to protect outside stockholders from predatory practices by insiders. This legal structure is contained mostly within the securities laws as embodied in the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, all as amended. Enforcement of stockholder rights against insiders is undertaken by the regulatory authorities themselves and through the private bar, which brings representative and derivative class actions on behalf of stockholder groups. Left without these legal constraints, we have little doubt that many managements would be far less cognizant of the stockholder's best interests than is now the case.⁵

The third general theory, that of Graham and Dodd, describes stock market behavior. In brief, it notes the tendency for earnings paid out as dividends to have a greater market value than earnings retained. Graham and Dodd note:

For the vast majority of common stocks, the dividend record and prospects have always been the most important factor controlling investment quality and value.

In the majority of cases, the price of the common stock has been influenced more markedly by dividend rate than by the reported earnings:

Because (1) dividends play a dominant role in the market price of a typical common stock and (2) the discounted value of near dividends is higher than the present worth of distant dividends, of two companies with the same earning power and in the same general position in an industry, the one paying the larger dividend will almost always sell at a higher price.⁶

While these statements are realistic, their thrust seems to us to be misdirected. A more appropriate emphasis would be not on where a stock would sell in the near future because of its dividend, but rather on which stock—the low dividend payer or the high dividend payer—is more attractive to which type of investor.

CASH DIVIDENDS AS A FACTOR IN MARKET PERFORMANCE

If we were to generalize about the subject, we would approach the stock market impact of dividend payments differently from the way Graham and Dodd do. Other things being equal, the common stock whose issuer is a low dividend payer would be the better buy for investors seeking market appreciation, rather than a cash-carry. As Graham and Dodd agree, of two companies with the same earning power and with the same general position in the industry, the lower dividend company should tend to sell at the lower price; this, by itself, should make the lower dividend payer a more attractive buy for many investors. Furthermore, the company whose common stock is available at the lower price will have more room to increase its dividend and eventually command

the higher price. It appears likely that market price action may be more affected by the trend in dividend payments than by the amount of the dividends. The company paying the lower dividend will retain more earnings and in the future be in a better position to improve its industry status, its financial position, and therefore its earnings. It is entirely possible that, assuming the companies are in the same position now, had the company paying the lower dividend paid a higher dividend, it could never have achieved the position it now has.

A reasonable countervailing argument can be made that high dividend payers tend to be the better buy because a high payout ratio may indicate a management more attuned to meeting the desires of most outside stockholders. We believe this argument has elements of validity. Its applicability, however, is limited, since dividend policy does not appear to us to be a particularly good measure of either management ability or management interests. Insofar as there is a tendency for there to be a strong relationship between the long-term economic interests of a company and the long-term prices of that company's common stock, stockholders are eventually benefited by small or no dividends, to the same extent as companies benefited from profitably reinvesting cash that would otherwise have been paid out as dividends.

Graham and Dodd also state:

Long experience has taught investors to be somewhat mistrustful of the benefits claimed to accrue to them from retained and reinvested earnings. In very many cases, a large accumulated surplus failed not only to produce a comparable increase in the earnings and dividends, but even to assure the continuance of the previously established rate of disbursement.⁷

This statement is, of course, true, but it is equally true that too high dividends can hurt companies and stockholders far more than conservative dividend policies. There are many cases where companies paid high dividends long after it was prudent for them to do so, and as a consequence the stockholders suffered mightily. Examples range from CIT Corporation, General Motors and Chrysler Corporation prior to their 2009 Chapter 11 filing, to Middlesex Water, U.S. Pipe and Foundry, and United Fruit. These companies and their long-term stockholders would have been better off had dividend rates been lower and had the companies retained earnings to both finance necessary expenditures and provide a cushion against business adversities.

The Graham and Dodd approach has validity from a stockholder's short-run viewpoint, but does not appear to give much weight to the legitimate long-term needs of a corporation. The Graham and Dodd approach does recognize corporate and stockholder long-term needs if it is assumed that high dividends result in high stock prices that an issuer is able to take advantage of by issuing new stocks at prices based on market values. But this assumption is largely unrealistic. Except for public utilities, most corporations, as a practical matter, can issue new common stock only very occasionally, either in sales for cash or in merger and acquisition transactions.

We are in agreement with Graham and Dodd that corporate dividends and corporate dividend policies are likely to have a meaningful impact on common stock prices. As we point out above, though, different assumptions bring different results. For the broad range of companies, we cannot conclude that high dividends are better than low dividends.

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THE PLACEBO EFFECT OF CASH

DIVIDENDS

Cash dividends increase in importance for securities holders insofar as the holder lacks confidence in the outlook or management or in the reliability of the disclosures used by him in his buy, hold, or sell decisions. Put simply, for the uninformed or distrustful stockholder, cash dividends are a hedge against being wrong. Truly a bird in hand (cash return) for them is worth two, three, or four times the bird in the bush (the appreciation potential arising out of a company's reinvesting retained earnings and its common stock's being available at a lower price because of the lower dividend).

CASH DIVIDENDS AND PORTFOLIO MANAGEMENT

Dividends increase in importance with the shareholder's need for immediate cash income from his portfolio. Of course, when the prime lending rate exceeds 7 percent, and good grade common stocks return no more than 6 percent, it may be asked: Should those in need of income invest in common stocks at all? Such a question misses several points. First, many shareholders desiring income are in locked-in positions, unwilling to sell common shares they own because of, say, an ultra-low cost basis for income tax purposes. Second, many investors seek inflation hedges—securities that combine high cash returns with appreciation potential. Third, dividend receipts may be tax advantaged for shareholders subject to U.S. income taxes. Specific common stocks are likely to have substantially more appreciation potential than senior securities (either because their prices are unusually depressed or because equity holders can participate in the long-term growth of a business), whereas the holder of a senior security without equity privileges has a contractually defined limit on potential appreciation. Although it is true that the smaller appreciation potential of senior securities is made up for, at least in part, by the fact that they are easier to finance, this finance factor may be academic for the prudent outside investor who abhors borrowing on margin to invest in the securities of companies about which his knowledge is limited, over which his control is nil, and where his costs of borrowing might exceed his return on his portfolio.

Dividends become a negative factor for shareholders who want tax shelter or who have no need for income and are confident that management will reinvest retained earnings on a highly productive basis. In a sense and except for the fact that it does not provide a cash return, unrealized appreciation is the ultimate in income tax shelter.

Dividend income tends to be unimportant, also, where a company is not essentially a going concern, but rather is in a resource conversion or a workout situation (that is, with prospects of being liquidated, acquired, or reorganized), because of the expectation by shareholders that realization will be obtained on a more advantageous tax basis than if dividends were paid.

An attractive feature of securities with a high cash return is the positive cash-carry. A safe high cash return not only eases any investor's pain where performance is disappointing, but also makes a transaction eminently more affordable and easier to finance than would otherwise be the case. This is so because of the benefits a cash-carry brings to the financial position of a holder.

EXAMPLE

Back in 1979, Source Capital Preferred sold at 24, and paid a \$2.40 dividend; it was a margin-eligible security. Assuming an investor could borrow 50 percent of the cost of 10,000 shares, incurring a 7.5

percent interest cost, his cash-carry would have been as follows:

10,000 shares of Source	\$240,000
Capital Preferred @ 24 net	
50 percent of purchase price	\$120,000
borrowed	
Cash investment required	\$120,000
Annual dividend income on	\$24,000
10,000 shares	
Annual interest cost on	\$9,000
borrowings of \$120,000	
@ 7.5 percent	
Cash and carry gain	\$15,000
Cash return on investment of 12.50 percent	
\$120,000	

We believed that the Source Capital Preferred \$2.40 dividend was exceptionally safe and that the security was *de facto* an AAA issue. It was the senior security of a large, conservatively managed, registered Investment Company, which was forbidden by law to incur any material amount of obligations that would be senior to this preferred stock issue.

Against this background and assuming our analysis is absolutely correct, it may be instructive to review for the reader those factors that a portfolio manager ought to consider before determining that a cash-carry investment in Source Preferred is both attractive and suitable. First, the investor who believes the cost of borrowing will increase may forgo a Source Preferred investment. Since the investor may not be able to control the cost of his borrowing, there could be adverse cash-carry consequences if interest rates on the bank borrowings increase to over 10 percent and the investor is required to retire or pay down his bank loan at a time when he is unable to refinance. Second, there is a risk of depreciation in the market price of Source Capital Preferred stock if long-term interest rates rise markedly or the market becomes irrational. Some indication of the depreciation possibilities inherent in Source Preferred can be gleaned from the price history of the issue: in 1974, Source Capital Preferred was quoted as low as 17³⁸/₈ bid. It ought to be noted, too, that Source Capital Preferred was not overly marketable; there were only about 1.6 million shares outstanding, and these were traded in the over-the-counter market in small volume. Any security holder who might have to sell at any particular moment might be able to dispose of his shares only at discount prices.

While the positive 12.5 percent cash-carry return appeared attractive by itself, appreciation opportunities were limited for the issue. Commencing September 30, 1977, the issue became callable at the option of the company at \$30 per share, and the call price would decline each year until it reached \$27.50 in 1982. The issue would have not, in rational markets, sold at any appreciable premium over its call price.

Alternative opportunities could have been more attractive. We do not know the entire universe of securities, but conceivably there could have been other issues that offered a better combination of cash-carry safety of income and high return.

Unlike most other domestic preferred stocks, Source Capital Preferred had only limited special tax benefits for corporate holders, through the availability of an 85 percent tax exclusion (the tax exclusion is at the time of this writing 70 percent). As an investment company electing to be taxed under Subchapter M of the Internal Revenue Code, Source Capital itself was not a taxable entity, but instead *flowed through* its income to the shareholders. Unless and until the bulk of Source Capital's investments are in qualified dividend-paying equities rather than interest-paying debt instruments, only a portion of Source Capital Preferred's dividend payments to its corporate stockholders would be tax-sheltered. Back in 1979, a corporate holder of Source Preferred was subject to full income taxes on about two thirds of the dividends, and only in connection with about one third could the corporate holder exclude 85 percent of the payments from its taxable income.

Finally, Source Capital Preferred lacked general recognition by others as a high-quality issue. This factor almost automatically excluded the stock from consideration for all sorts of institutional and quasi-institutional portfolios.

One of the pervasive elements of corporate finance is demonstrated by this cash-carry example. How attractive a security or situation is, is in part a function of how financially strong it is. With the prime lending rate of 7³/₈ percent, Source Capital Preferred at 24 was in our view a very attractive cash-carry situation for many; were the prime 10½ percent, not only would there be no cash-carry for Source Capital Preferred at 24, but in the absence of the issue's being called or tendered at a price in excess of 24, the stock would have been unattractive.

CASH DIVIDENDS AND LEGAL LISTS

Cash dividend income is a legal or quasi-legal necessity for many securities holders. Legal lists in many states require fiduciaries' common stock investments to be restricted to securities that are currently paying dividends and have paid dividends for a number of years in the past. The accounting practices for business entity investors (such as insurance and investment companies) usually permit them to report as income on common stock investments where they hold less than 20 percent of the issue only the dividends received. These stockholders cannot report as net income any equity in the undistributed earnings of companies whose common stocks they hold in their portfolios. The accounting rule governing this is contained in FASB Accounting Standards Codification (ASC) 323, which states that there is a presumption that undistributed equity in profits or losses of companies whose stocks are in the portfolio are to be included in the business entities' accounts if 20 percent or more of the stock of such a company is owned.

CASH DIVIDENDS AND BAILOUTS

The ability to convert assets to cash tends to be a key consideration for many buyers of securities for control purposes. It always is a key consideration for outside investors.

Companies with pools of unencumbered liquidity tend to be looked upon as attractive acquisitions for control buyers, in part because there is a lack of uncertainty about minimum values to anyone. Furthermore, large pools of cash may frequently be worth substantial stock market paper premiums to acquirers of corporate control when those acquirers pay in paper consisting of warrants, common stocks, preferred stocks, and subordinated debentures, not cash.

EXAMPLE

Schenley Industries' cash was worth a substantial premium over stated value to Glen Alden in 1968 and again in 1971 when Glen Alden acquired Schenley securities mostly by the issuance of subordinated debentures. Roan Selection Trust's cash also was worth a premium to Amax in 1970.

Assuming that an investor can have no element of control over the company in whose common stock he has invested, that stockholder will want to have opportunities sooner or later to convert that investment into cash. There are but three ways that such a minority interest can be converted to cash: first, the security can be marketed; second, the issuer can become involved in resource conversion activities, such as mergers and acquisitions, liquidations or going-private transactions; and third, cash dividends can be paid to stockholders. Frequently, the prospect of cash dividends is the only meaningful assurance a minority investor may have that a cash return will be received on an otherwise locked-up investment.

Without being exhaustive, there are a few simple rules about minority interest investments of which an OPMI in public companies ought to be aware. Once a company has become public, it is required to remain a filing company with the Securities and Exchange Commission as long as there are 300 or more stockholders of record of any class of equity securities.^a For control stockholders, there usually are important advantages to having 100 percent control of a company, compared with less than 100 percent. Also, there are usually important advantages in being private rather than public. However, regardless of the state of incorporation, majorities having a "business purpose" do have the right to force out the minorities through a vote of the requisite number of shares, or

where the majority owns enough shares, through a short-form merger, which does not require a vote. Whether compensation to the minority in the force-out has to be adequate depends in part on state law, including the adequacy of appraisal rights for dissenting stockholders, and on compliance with appropriate disclosure requirements under federal securities laws.

It is our experience that the acquisition of a portfolio of minority interests is attractive because of the likelihood that parents will eventually attempt to acquire, through mop-up mergers, 100 percent interests in subsidiaries at prices reflecting substantial premiums above stock market prices (which are depressed in part because such securities are liable to lack marketability).

In acquiring these types of minority interest securities, however, it frequently is important to the investor that such securities pay dividends, in part because an investor may need income and in part because the receipt of dividends may be far more certain than cash tender offers or mop-up mergers that may never occur. When situations exist where the parent company finds it essential to receive cash from subsidiaries in the form of dividends on outstanding common stock, cash income may be virtually assured for the outside investor. Two such subsidiaries were Reliance Insurance Company, 97 percent owned by the Reliance Group, and Mountain States Telephone and Telegraph, 88 percent owned by American Telephone and Telegraph. Both Reliance Insurance and Mountain States Telephone had relatively liberal dividend policies.

^a Section 12(g)(4) of the Securities Exchange Act of 1934 states: *Registration of any class of security pursuant to this subsection shall be terminated ninety days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than three hundred persons. The Commission shall after notice and opportunity for hearing deny termination of registration if it finds that the certification is untrue. Termination of registration shall be deferred pending final determination on the question of denial. Companies filing with the Securities*

THE GOALS OF SECURITIES HOLDERS

It is important within the fundamental finance approach to distinguish between the goals of virtually all holders of senior securities and many holders of equity securities. A problem arises because many commentators impute to equity owners the same ultimate goals that exist for debt owners.

Many owners of senior securities, especially financial institutions, are interested solely in cash return—interest payable in cash, plus a return of principal, also payable in cash. Most senior securities have limited lives, so that if repayment of principal in whole or in part cannot be obtained from sale in the market, in time repayment will be obtained from the issuer.

In contrast, equity holders may sometimes be interested in cash returns in the form of dividends and the ability to sell shares, not to the issuer, but to the market. However, some equity holders are also interested in an earnings return—in having a perpetual participation in an enterprise that through the plowback of earnings increases in value over time. Such investors are under no illusion that increases in value will be, or are necessarily likely to be, reflected in stock market prices at any given moment.

It is probable that most long-term equity investors have a variety of goals, combining the pure cash-return goals characteristic of many senior security holders, and the earnings return goals characteristic of a person for whom dividends have significant tax disadvantages and who is not particularly aware of stock market price fluctuations. We think that many economic, accounting, and stock market theorists fail to recognize the existence of this second type of investor.

SUMMARY

It is important for investors relying on a fundamental finance approach to investing to understand the roles that cash dividends play in security analysis, portfolio management, and corporate finance. For us, cash dividends serve six principal roles: (1) dividend levels or changes in levels seem likely to impact stock market prices; (2) dividends are also important placebos for noncontrol purchasers of common stocks who lack the confidence in the merits of the equity securities they hold; (3) they are important in portfolio management where prudent managers seek a positive cash-carry; (4) the receipt of dividends may be a legal necessity for certain fiduciaries; (5) they are a form of tax-advantaged distribution for U.S. taxpayers; and (6) they are one form of cash bailout from holding common stocks. We also review the role of dividends as postulated in traditional theories.

* This chapter contains original material, and parts of the chapter are based on material contained in Chapter 14 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (© 2006 by Martin J. Whitman and Martin Shubik). This material is reproduced with permission of John Wiley & Sons, Inc.

¹ John Burr Williams, *The Theory of Investment Value* (Cambridge, MA: Harvard University Press, 1938).

² Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," *American Economic Review* 48, no. 3 (June 1958).

³ Benjamin Graham, David L. Dodd, and Sidney Cottle, *Security Analysis: Principles and*

Technique (New York: McGraw-Hill Book Company, 1962).

⁴ John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1967).

⁵ The one group that might be viewed in the broadest perspective as dedicated almost solely to the interests of outside, passive investors is the Securities and Exchange Commission. On a practical level this is not wholly true, but it is our view that the Securities and Exchange Commission has been more dedicated to the interests of OPMLs than any other group in the economy.

⁶ Graham, Dodd, and Cottle, *Security Analysis*, pp. 480–481.

⁷ *Ibid.*, p. 484.

CHAPTER 11

The Appraisal of Managements and Growth: GARP versus GADCP*

New Framework for the Appraisal of Managements

Managements Attuned to OPMI Interests

Managements as Resource Converters

Tradeoffs

Growth: GARP versus GADCP

Growth at a Reasonable Price (GARP)

Growth at Dirt Cheap Prices (GADCP)

Summary

The appraisal of managements is, indeed, difficult. In a Graham and Dodd primacy of the income account approach (or any other primacy of the income account approach) managements are appraised almost solely as operators of strict going concerns. Experience tells us that this is not realistic. Superior managements seem to focus on the same things a value investor focuses on as a buy and hold investor, that is, long-term wealth creation. The generation of reported earnings from operations tends to be the least desirable method for creating wealth, simply because reported earnings from operations are less tax sheltered than are other methods of wealth creation. This is one of the reasons why resource conversion activities by corporations seem to have grown in importance at the expense of ordinary going concern activities. Also highly important for long-term wealth creation are attractive access to credit markets and equity markets. Unlike most stock market participants, the primary focus of these managements is not on what periodic reported earnings per share, or periodic earnings before interest, taxes, depreciation and amortization (EBITDA), might be.

In creating wealth, these opportunistic managements realize that there tend to be many ways to create wealth besides enjoying operating earnings. These other methods of creating wealth include enjoying super-attractive access to capital markets; being able to make opportunistic acquisitions of other companies and other assets; being able to opportunistically launch new businesses; and being able to take advantage of basic mispricing in securities markets in order to, *inter alia*, repurchase outstanding common stock, spin-off glamorous subsidiaries, or liquidate assets in whole or in part.

NEW FRAMEWORK FOR THE

APPRAISAL OF MANAGERMENTS

Once it is recognized that superior managements seek *long-term wealth creation*, and that their businesses generate wealth by being engaged in both *going concern* and *resource conversion* activities, it follows that managements should be appraised based on three interrelated dimensions:

1. Management as *operators* of going concerns
2. Management as *investors*, employing and redeploying the assets of the business
3. Management as *financiers*, obtaining the necessary capital on an attractive basis to conduct company activities

We want the managements of the companies in which we would invest to be attuned to the interests of outside passive minority investors (OPMIs); to be competent as day-to-day business operators; and to be competent as wealth creators as resource conversion opportunities emerge opportunistically from time to time.

Experience tells us that we have achieved the best results when associated with superior managements who were able to be opportunistic on a long-term basis, and took advantage of the resources in the business, which included:

- Strong financial position (all the following examples)
- Efficient manufacturing abilities (Toyota Industries)
- Ability to make attractive acquisitions (Wheelock, Brookfield Asset Management, Berkshire Hathaway, Cheung Kong Holdings)
- Having the ability to employ excess capital (surplus-surplus) profitably (Berkshire Hathaway)
- Having the ability to access capital markets, on a super-attractive basis (Brookfield Asset Management, Facebook, Inc.)
- Having the ability to use a superior financial position to strengthen a competitive position (AVX)
- Having the ability to maintain profit margins during periods of increased competition and severe economic downturn (POSCO)

Experience has also taught us that the vast majority of misjudgments often revolve around being in bed with the wrong management, rather than purely financial factors.

MANAGERMENTS ATTUNED TO OPMI INTERESTS

As to being attuned to the interests of OPMIs, it can safely be stated that there does not exist any publicly traded company where the management works exclusively in the best interests of OPMI stockholders. Rather, all financial relationships, including those between managements and OPMIs, combine communities of interest and conflicts of interest. The best OPMIs can hope for is that there is a distinct bent by individual managements toward the communities of interest side. It would be naïve to think that any management would forgo management compensation, and management entrenchment, just because some of these management privileges might be perceived as giving rise to a conflict of interest with OPMIs.

It ought to be noted that there tend to be conflicts of interest between short-run, market-sensitive OPMIs and long-term, buy-and-hold OPMIs like us. We are very much against corporate

beefing up of quarterly reported earnings per share when, and if, the striving for periodic earnings per share diminishes opportunities for long-term wealth creation. Striving for quarterly earnings per share often tends to reduce wealth creation opportunities when alternative methods of wealth creation might be available. Good examples of managerial emphasis on the short-term effects rather than a long-term view are mortgage lending by Key Corp. and other banks in 2005 and 2006, and the merger of AOL into Time Warner in 1999 at the height of the dotcom bubble.

Example

Operating earnings are taxable, and unrealized appreciation is not taxable. Not paying taxes increases resources available for wealth creation. It makes sense for corporations interested in wealth creation to emphasize earnings per share when such emphasis will give the company better access to capital markets, especially equity markets, than would otherwise be the case. This, however, has virtually no relevance for us since the common stocks in which we would invest are issues of companies with little or no need to access capital markets, especially equity markets.

MANAGEMENTS AS RESOURCE CONVERTERS

Managements can and do create wealth by acting as opportunistic investors. This opportunism is often associated with their companies having a strong financial position, which they can use to effect attractive acquisitions.

EXAMPLE

Wharf in 2012 made an attractive investment into the financially strapped Mainland China homebuilder Greentown China Holdings. Wharf invested HK \$5.1 billion (U.S. \$654 million) into Greentown, half in common stock and half in a convertible debenture. Upon conversion, Wharf will end up with an approximate 35 percent ownership interest in Greentown equity. Greentown is one of the foremost

residential builders in Mainland China. Its principal problem seemed to have revolved around a poor financial position. That poor financial position seems to have been cured by Wharf's HK \$5.1 billion capital injection. The purchase price will equal about HK \$5 per Greentown share. Greentown common at this writing sells between HK \$8 and \$9 per share.

One example of management leaving something on the table that could have benefited stockholders involves the 2005 acquisition of Instinet by NASDAQ.

EXAMPLE

In April 2005, Instinet Group entered into a merger agreement with NASDAQ under which Instinet shareholders would receive total consideration of \$1.8 billion in cash. As part of the transaction, Silver Lake agreed to buy Instinet's agency brokerage business for \$207 million, which represented a discount to the subsidiary's tangible book value. In May 2005, Third Avenue Management submitted an acquisition proposal to Instinet in which it offered to "stand in the shoes" of Silver Lake and purchase the agency brokerage for \$307 million, subject to limited due diligence but no financing contingency. Instinet rejected the proposal as the board concluded that it was not reasonably likely to constitute a "superior proposal" for the entire company. In December 2005, the merger with NASDAQ (and Silver Lake) was completed. In February, 2007, Silver Lake sold Instinet's agency brokerage business to Nomura for a reported price of nearly \$1.2 billion or a premium of more than five times its purchase price and nearly four times the price offered by Third Avenue.

Mistakes by managements involved with acquisitions are also common.

EXAMPLE

One of the more egregious mistakes might have occurred when in 2008 Bank of America acquired 100 percent control of Countywide Financial Corp. in a merger transaction. In the transaction, Bank of America should have made absolutely certain that it was not assuming any liabilities of Countrywide. Those liabilities would remain the obligations of Countrywide but were not obligations that would attach at all to Bank of America. This appears not to have been the case.

Assuming the liabilities of poorly financed subsidiaries ought to be avoided like the plague by astute management.

EXAMPLE

In 2012 questions were raised by creditors of Residential Capital LLC (ResCap) as to whether or not all of Ally Bank (formerly named General Motors Acceptance Corp) is to be responsible for the obligations of ResCap a wholly owned subsidiary of Ally Bank. The Bankruptcy Court has appointed an examiner to explore the issue.

Realizing current losses on a one-time basis is a recognized method for making future earnings better than they otherwise would be. Many companies that take huge write-downs—largely on injudicious acquisitions and on expansion undertaken during a period of excesses—serve as good examples. Taking those huge write-downs came to be known as big-bath accounting. Examples of companies that took big baths at the outset of the 2008–2009 financial crisis included Merrill Lynch, Citigroup, and General Motors.

EXAMPLE

In 2012, Tellabs took a \$106 million charge-off writing off completely its injudicious acquisition of WiChorus in 2009.

Most companies that take big-bath write-downs account for them as nonrecurring, extraordinary events. This bothers many who felt that in reporting profits the big baths should be treated as a normal, recurring event. It seems to us, though, that much of security analysis and much of accounting is directed toward appraising businesses and their managements solely as operations and operators. If so, the big baths are indeed nonrecurring. As we have already pointed out, a feature that differentiates us from conventional business and security analysts is that

convention (be it Graham and Dodd or modern capital theory) seems to emphasize operations at the expense of *resource conversion* factors, whereas we tend to de-emphasize operating factors, or rather, give *resource conversion* factors greater importance for most companies most of the time.

Insofar as a company is to be appraised as a *going concern* and managements as *operators*, it is logical to view the big bath as nonrecurring. Insofar as a company and a management are to be appraised as *investors* responsible for obtaining a return from the resources entrusted to them by being *operators*, *financiers*, and *investors* in new productive assets and by being specialists in mergers and acquisitions (that is, by viewing them as *resource converters*), there is no such thing as nonrecurring charges or expenses. Nonrecurring charges are the method used in Generally Accepted Accounting Principles (GAAP) accounting to record past investment mistakes.

TRADEOFFS

No management is perfect. The factors that allow the managements to be opportunistic also bring to light certain shortcomings, at least from the viewpoint of shorter-term stock market speculators. During good times, when interest rates are low, the maintenance of a strong financial position obviously translates into a willingness of management to sacrifice increased return on assets (ROA) and return on equity (ROE) in order to enjoy the safety benefits and the opportunistic benefits inherent in having a strong financial position. Focusing on long-term opportunism rather than periodic earnings per share, as reported, tends to not sit well with most OPMIs. A company with a strong financial position either does not need access to capital markets or else controls the timing as to when they would access capital markets. Given this, the managements tend to be nonpromotional, and at times, hardly interested at all in what Wall Street thinks. For better or worse, we would opt for managements more interested in creditworthiness than enhanced ROE.

The traditional focus on *strict going concerns* and the resulting view of managers only as operators is pervasive and often leads to misleading conclusions about the dynamics of wealth creation.

EXAMPLE

In the book, *Value Investing: From Graham to Buffett and Beyond*, by Greenwald, Kahn, Sonkin, and Van Biema (John Wiley & Sons, 2004), there are discussions of net asset value (NAV). An important point in the book revolves around the view that if the market price of a common stock is well above the reproduction value of assets, the company and the industry, in the normal course of events, will draw new competition which will result in diminished returns unless the company can build a moat to insulate itself from new competition (e.g., Coca-Cola, Gillette, and WD-40). From a *strict going concern* point of view, this observation seems quite valid. From a corporate management point of view, though, it seems

to be incomplete. In the hands of a reasonably competent management, an overpriced common stock tends to be an important asset with which to create future wealth by issuing that common stock in public offerings, and in merger and acquisition transactions.

On the opportunism issue, we are convinced it is very difficult for most managements to be opportunistic if their financial positions are such that they have to be supplicants to creditors—whether those creditors are financial institutions, trade vendors, or landlords. As we explain in Chapter 7, a strong financial position—that is, being creditworthy—gives managements options they would not have otherwise. Opportunism is one such option. We also explain that a strong financial position may not be needed when management is associated with and the company is controlled by sponsors who are extremely competent at accessing capital markets on a super-attractive basis even in the face of weak financial positions. We show an example of this situation in Chapter 25.

GROWTH: GARP VERSUS GADCP

In *The Intelligent Investor*,¹ Benjamin Graham defined a *growth common stock* as a term that applied to one that had increased its earnings per share in the past at well above the rate for common stocks in general and that was expected to continue to do so in the future. He recognized then that these stocks would be attractive to buy and to hold provided the price paid for them was not excessive. Thus, Graham laid out the current day concept of GARP. GARP stands for “growth at a reasonable price.” GARP is a usual standard for growth investing in the financial community by OPMIs, such as mutual funds or individual investors.² In contrast we advocate the concept of “growth at dirt cheap prices” or GADCP, which is what investors following a fundamental finance approach ought to try to accomplish in making most of their investments.

GARP analysis tends to be quite different from GADCP analysis as we explain below.

GROWTH AT A REASONABLE PRICE (GARP)

GARP analysis focuses strictly on forecasting future flows, whether such flows are revenues, earnings, or cash. An attractive common stock purchase is deemed to exist where future forecasted growth rates are greater than current ratios of price to flows. Thus, a common stock is usually deemed attractive under a GARP analysis if it is selling at 20 times earnings and the forecasted future growth rate for earnings is something more than 20 percent compounded, say 25 percent compounded. However, the same common stock under a GARP analysis would not be attractively priced at 20 times earnings if the future growth rate were estimated to be something less than 20 percent per annum compounded. A summary statistic commonly used in GARP analysis is the PEG ratio.³ The PEG ratio is the ratio of the P/E ratio and the expected future growth rate in earnings. A common stock selling at a PEG ratio lower than one (expected growth rate in earnings is higher than the P/E ratio) is attractively priced under a GARP analysis. The converse is true if the common stock is selling at PEG ratios substantially higher than one.

EXAMPLE

Apple, Inc. common stock is often cited as one selling at very attractive prices under a GARP analysis. At the beginning of August 2012, Apple Computer common was selling at a NTM PEG ratio of 0.55, which indicated that the expected short-term growth rate in earnings for the company was almost twice its market P/E ratio of 15 times.

In GARP analysis, heavy weight is placed on the past earnings record. Indeed, in much of GARP analysis it is assumed, in linear fashion, that future growth rates will approximate the growth rates achieved over the past one to five years. Rarely, if ever, is any weight at all given to balance sheet considerations in making forecasts, whether those balance sheet considerations involve the quality of resources in a business or the quantity of resources existing in a firm.

GARP analysis tends to revolve around a very short-run focus. If the immediate revenue, earnings, or cash flow outlooks are poor, common stock investment is to be forgone regardless of long-term prospects. A corollary of this is that the typical GARP securities buyer is short-run oriented and tries to buy at, or near, bottoms for securities prices.

Industry identification is very important in GARP; the securities buyer wants to get into industries that are generally recognized as growth industries in the financial community, say social media. Quite often, there is no independent analysis of growth potential, but rather only an acceptance of the generally recognized consensus. The underlying problem with going along with the generally recognized consensus is that the investor tends to buy what is popular when it is most popular. In other words, the investor has to pay up. Historically, buying what is popular when it is most popular has been a prescription for disaster for investors, whether it was acquiring RCA Common in 1929, real estate tax shelters in 1985, junk bonds in 1988, dotcom companies in 1999 and social media companies in 2012.

GROWTH AT DIRT CHEAP PRICES (GADCP)

In GADCP, there is no emphasis on estimating future flows. Rather it is recognized that growth in common stock prices can come, and frequently does come, from sources other than corporate operations. Growth can come from judicious acquisitions (Capital Southwest Common); creating unrealized, and unrecorded, appreciation in asset values (Forest City Enterprise Common, Hopewell Holdings Ordinary); creating hidden assets in the form of increases in adjusted book value (Carlyle Group); having companies taken over by others at premium prices (Brookfield Asset Management); and possibly participating in corporate restructurings (Nabors Industries).

In forecasting future flows of revenues, earnings, or cash flows, no exclusivity in making these forecasts is given to the past earnings record under a GADCP analysis. It is recognized under GADCP that the quality of resources in a business and the quantity of resources in a business tend to be equally important, and for some companies are more important than the past record in making reasonably accurate forecasts of future flows. This is simply giving recognition to ROE and ROA as part of the forecasting process with Equity and Assets being balance sheet items.

EXAMPLE

Society Corporation's position in the early 1960s is one example of this. Society Corporation was a bank holding company based in Cleveland, Ohio. At that time, banks' ROE was between 8 percent and 12 percent. Society, with a net worth of about \$50 a share, was earning about \$1.50 a share from operations when it converted from a mutual savings bank to a commercial bank holding company in 1962. This equaled an ROE of only 3 percent. A market participant could reason with a fair degree of confidence that over time Society probably would be earning a return on its equity close to that which was being achieved in the commercial banking industry in general. At least, there did not appear to be any insurmountable problems preventing this. Furthermore, book value, too, would be steadily increasing. The anticipated results occurred; reported earnings increased year by year, and by 1966 operating earnings were \$5 per share (or a 35 percent annual compounded rate of growth) on a year-end book value of \$62. The prediction of Society Corporation's future earnings growth could not have been based on the past earnings record. An examination of the asset values and the belief that such asset values would be used much the way other commercial bank holding companies used theirs were the basis for the earnings growth forecast. This approach is probably better described as a *resource conversion* approach to analysis rather than a strict *going concern* one. Why? The key item in evaluating Society Corporation was the probability that it would convert its assets to more productive uses, not that it would continue using them in the same way as in the past.

what techniques are used to make them, are going to prove to have been inaccurate. It is just too difficult to properly put into forecasts factors such as competitive forces, technological innovations, inexperienced managements, business cycles, access to capital markets and acts of God. Knowing of the inherent unreliability of its forecasts, we restrict our common stock investments to issues that enjoy very high-quality resources where we can acquire its interests at prices that represent a meaningful discount from the estimated quantity of resources that exist in a business.

GADCP is inherently long-term conscious. Indeed, securities markets tend to be efficient enough that a GADCP investor is unlikely to find issues at attractive prices unless the near-term outlook is poor to clouded.

Industry outlooks are as important for GADCP as they are for GARP. However, under GADCP, industry outlooks are based on independent analysis rather than conformity with a general consensus. We concluded a few years back that semiconductor equipment companies would have to participate fully in the growth of the Internet and telecommunication industries simply because the Internet and telecommunications could not come close to realizing their potentials unless there also occurred a dramatic increase in demand for increasingly sophisticated semiconductor chips. At that time, there was no recognition of this thesis within any Wall Street general consensus. We therefore could acquire the common stocks of well-financed semiconductor equipment companies such as Applied Materials or Intel at prices that were probably lower than a first-stage venture capitalist would pay were these corporations being financed as start-ups.

Many of these growth stocks do not have general recognition, and so they sell at very modest prices. Examples in mid-2012 included Applied Materials, Intel, Brookfield Asset Management, Cheung Kong Holdings, Hang Lung Group, and Wheelock & Co.

A large variety of factors enter into forecasts of future growth in NAV. Each set of factors is particular to the company being analyzed. For example, a principal element for forecasting growth for various Hong Kong companies in 2012 is the belief that mainland China, where each company has massive presences, is more likely to grow in the next three to five years than almost any other industrialized part of the world, whether Europe or North America. These Hong Kong companies are Wheelock & Company, Henderson Land, Cheung Kong Holdings, and Hang Lung Properties. The forecast of growth for Brookfield Asset Management, on the other hand, is based largely on an appraisal of management, whom we believe is super-skilled. A similar appraisal of management is key to our belief in the NAV growth potential for Capital Southwest Corporation.

SUMMARY

The view of businesses as pure going concerns has led to appraising managements only as operators. Once one recognizes that businesses generate wealth both through going concern and resource conversion activities, it becomes apparent that managements should be appraised not only as operators but also as investors and financiers. It is our experience that investment success is more often related to being associated with managements who are opportunistic and take advantage of the resources of the business than by any other financial factor.

The current paradigm of growth investing is GARP or growth at reasonable prices. We identify limitations of GARP, which stem from its underlying assumptions including: the view that businesses are pure going concerns, heavy weight is given to the past earnings record when forecasting future earnings growth, industry identification is important to GARP, acceptance of the generally accepted consensus of growth potentials rather than reliance on independent appraisals of growth potentials, a tendency towards buying what is popular when it is most popular. In contrast, we advocate using GADCP investing, or growth at dirt cheap prices investing. In GADCP we give no primacy to flows in forecasting future growth but rather consider the quantity and quality of resources in a business as well as managements' appraisals as investors and financiers, and potential resource conversion opportunities while being extremely price conscious. A large variety of factors enter into the determination of growth potentials and we provide examples that highlight such factors.

* This chapter contains original material, and parts of the chapter are based on ideas contained in the 2004 4Q letter to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ Benjamin Graham, *The Intelligent Investor* (New York: Harper & Row, Publishers, Inc., 1973).

² The GARP concept appears to have been popularized by Peter Lynch in his 1989 *One Up on Wall Street* (New York: Fireside, 1989).

³ This ratio was developed by Mario Farina in his 1969 book *A Beginner's Guide to Successful Investing in the Stock Market* (Palisades Park, NJ: Investors' Press).

CHAPTER 12

The Significance (or Lack of Significance) of Market Performance^{*}

Market Performance and the Character of a Portfolio

Market Performance of Portfolios versus Individual Securities

Outsiders, Insiders, and Market Price

Professional Money Managers and Beating the Market

Perspective on Bailouts and the Significance of Market Performance

Summary

There is a common belief among many stockholders and lawyers and much of the judiciary that stock market prices are the one realistic measure of value, and that the only way to tell how an investor is doing is by valuing his securities portfolio from time to time, even daily, based on stock market prices. As discussed in Chapter 3, this is the *substantive consolidation* view of the world. Common sense tells us that this approach heavily distorts the facts of life because market prices are considerably less important to some security holders and some companies than they are to others.

For stock traders, there are realistic reasons for making stock market prices the only consideration. At the other extreme, for investors interested only in secure income, *weight to market* should be zero or on occasion even negative, because even though an investor has an ownership position in a credit or a common stock, it is conceivable that he would obtain more benefits from short-term declining prices than from steady or rising market prices. In gauging investment results for the vast majority of people and institutions, market performance at any moment should be given a weight of considerably more than zero and something quite a bit less than 100 percent. The precise weight, assuming that any precision is desirable or even necessary, should be determined by the individual investor.

The concept of weight to different elements of value may have originated in Delaware appraisal proceedings, where stockholders dissented from a merger or similar proceeding. In the now outmoded *Delaware block* valuation methodology, three elements of value—market value, earnings or investment value, and asset value—were determined, and separate weights were assigned to each of the three elements, with weight for all three elements totaling 100 percent. Through the determination of the three elements, each separately weighted, an ultimate value was determined. In the *Weinberger* decision¹ the court rejected this practice, holding that a proper valuation approach “must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court.” The more liberal approach mandated by the *Weinberger* court led the Delaware courts to consider a much broader array of factors in determining the fair value of a target corporation’s stock.

Market performance as a gauge of how an investor is doing deserves 100 percent weight when the particular investor does not know anything about the company in which he is investing other

than the most superficial stock market statistics, such as market price history, recent earnings, dividend rate, stock-ticker symbol, alleged sponsors and the latest popular “story.” It also deserves 100 percent weight when the investor’s financial and/or personal position is such that he is vitally affected, or he believes he is vitally affected, by short-term market fluctuations. One hundred percent weight to market also seems appropriate for sudden death securities; that is, issues where at a certain date, key events will occur as when an option expires, a tender offer concludes, or a merger transaction is consummated. Such people or situations, call for instant performance. Items that are perceived to be critical are inside information about corporate events that they believe will have market impact; technical systems that they believe will assist in forecasting general market trends and individual stock price movements; and trading information that can either be reacted to or used. Perhaps the most traumatic and significant event for this group is to see stocks go down, or even in some instances to see stocks fail to go up. Thus, there is a good rationale for their credos, Don’t let your losses run, and get out of stocks that are not moving.²

To us, it seems foolish to accept the short-term needs cited in the previous paragraph as the norm for purposes of promulgating various securities regulations and accounting rules, yet some of these rules and regulations seem directed strictly toward the desires and needs of those who think day-to-day market prices are all-important.

Many market participants, of course, do not weight stock market price as being of 100 percent importance or even anything close to it. Examples of investment groups that are either indifferent to market price fluctuations or hopeful that they will go down on occasion include individual stockholders who would benefit from low market valuations for, say, estate tax or personal-property tax purposes; investors who are primarily interested in maximizing their cash returns and/or continually creating cash for new investment from noninvestment sources; and those desiring to accumulate large positions, either to exercise control or to influence control shareholders.

It is our view that very few outside investors ought to endow short-run market performance with an all-consuming importance. First, for many, performance has to take a back seat to other considerations in terms of realizing such objectives as the creation of a reasonably well-assured regular cash income from interest and dividend payments. Second, for those following the fundamental finance approach, rarely if ever is emphasis given to short-run considerations. Frequently, timing as to when something will happen is indeterminate when securities appear attractive under our approach: Its four basic elements give no clues whatsoever to what near-term market performance might be like.³ Finally, the studies that are part of modern capital theory indicate that those who attempt to beat the market continuously do not usually do so when beating the market is defined as having a total return on a market risk-adjusted basis in excess of stock market averages.

We agree with the modern capital theorists that it is a losing exercise for almost all outside investors to try to beat the market by forecasting price movements over any particular length of time, say within the next year. To us, it is true in a perverse way that one cannot beat the market by trying to beat the market. Rather, superior long-term performance comes about by indirection—for example, by buying good values as determined under the fundamental finance approach, and sticking with those holdings in the absence of clear-cut evidence that a significant mistake has been made. Evidence of such mistakes will be found in the results achieved by the business rather than in the price of the business’s securities, which at any moment may or may not reflect business reality.

MARKET PERFORMANCE AND THE CHARACTER OF A PORTFOLIO

The importance of market performance depends in part on the character of a portfolio, and other things being equal, market performance will be more important when a portfolio is of a fixed size or subject to net withdrawals of cash, as compared with a portfolio that is the continual recipient

of new cash to invest. This latter portfolio is in the nature of a dollar averager, and provided that it consists of sound securities, market performance need not be an overriding consideration. Here, poor past performance means, at least in great part, that present purchases are being made on more attractive terms than in the past, whereas good past performances may spell less attractive current purchases if the underlying value of the security has not increased as much as the price of the security during the interim.

It should be noted, too, that dollar averaging diminishes the need to beat inflation, because changes in the value of money probably will, in the long run, be offset by changes in the returns on securities. This was particularly true during the fifteen years preceding 1978, when inflation was accompanied by rising interest rates. Cash that could have been invested in commercial paper to return 4 percent in 1964 could be invested the same way to return over 10 percent in 1974 and again in 1978. Cash returns available to such investors increased considerably more than did the cost of living. Among the beneficiaries from such inflation-cum-interest-rate developments were permanent investors in high-grade debt securities, provided new funds were being made available regularly for investment and reinvestment. Such investors included many young people with rising salaries and savings, as well as various types of insurance companies and pension plans. The opposite seems true in 2012. Because interest rates are at historic lows, new funds have to be invested for total return, not cash return.

The typical well-run property and casualty insurance company is, in part, an example of a dollar-averaging investor. Its performance is measured essentially by its net investment income— income from dividends and interest after all investment expenses except taxes. The insurance company's investment departments normally receive continuous new injections of cash from the underwriting departments, growing out of increases in premium volume and, it is hoped, from underwriting profits. For such companies, as long as interest is not defaulted and dividend rates on securities held in portfolios are not reduced or eliminated, the lower the market value of the portfolio, the higher the returns that will be earned on the new funds being invested. And the higher the returns, the faster net investment income will increase. Property and casualty investment departments do have some interest in upward market performance on individual securities, since managements prefer the securities they own to rise in price and the new money to be invested in debt or equities that are available at attractive prices. But as long as the business is adequately capitalized, such considerations are distinctly secondary to the primary purposes of the portfolios—the protection of the policyholder. That tends to restrict investments to generally recognized high-quality securities that are marketable, and to the creation of net investment income.

As a matter of fact, it was the continuing declines in the market value of portfolios of bonds and mortgages that made up the bulk of life insurance portfolios (since interest rates were on a generally rising trend) that contributed importantly toward making life insurance stocks, in general, one of the outstanding growth investments in the 20 years after World War II. Had the market value of their portfolios not been declining, the increases in investment income would have been much slower than was actually the case.

It is true that some insurance companies tend to be harmed in bear markets because their capital adequacy is measured by regulatory authorities on a basis that values common stocks at market. This is normally not a problem for insurance companies since the vast majority of their investments are in performing loans. Huge increases in net investment income arising out of new money being employed for high cash return cannot, in these cases, compensate for capital inadequacy. Nonetheless, the normal economic desires of such investors are that weight to market will be considerably less than 100 percent almost all the time.

MARKET PERFORMANCE OF PORTFOLIOS VERSUS INDIVIDUAL

SECURITIES

Market performance is a much more important gauge of investment results for a whole portfolio of marketable securities than it is for an individual security. For example, consider an investment program in unsponsored, special situations where the portfolio companies have high credit worthiness and where securities are selling at prices substantially (say, 50 percent or more) below what the companies would be worth as private corporations. At any one time there might be three to five such securities in a portfolio. The precise timing as to when any one of these securities might enjoy substantial price appreciation is indeterminate. However, if over a period of, say, six months to a year none of these securities appreciates even in a generally declining market, it is fair to conclude that investment results are poor. But the poor results would be attributable more to poor analysis (that is, the securities were not really attractively priced in the first place) than to other factors that explain poor performance for general market securities portfolios, such as weak general market conditions or an uncertain economic outlook.

The one time when market performance of portfolios that are attractive by fundamental finance standards seems bound to be poor compared with the general market, no matter how good the analysis of the securities, is during periods of raging bull markets in speculative-grade growth stocks, such as occurred from 1961 to 1962, in 1968, and in the late 1990s. Even in this situation, though, workout portfolios still should show at least fair returns—say, not less than 10 percent—on the market values of the funds invested.

It is important to note that one of the reasons outside passive minority investors (OPMIs) using our approach cannot give large weight to near-term market performance is that the factors that frequently will have greatest near-term market impact are not what the investor believes alters the fundamental outlook for the company in which he has invested. These factors, which he may not deem particularly important but which are likely to have a strong, immediate market impact, include the following:

- Cyclical changes in the economy
- Changes in general stock market levels
- Changes in interest rates
- Quarterly earnings reports
- Dividend changes

In considering the weight that should be given to stock market prices, it is important to remember that a stock market price is not business or corporate value, but a realization value based on the price at which a common stock could be sold in an OPMI market. Therefore, market value as a realization figure is a very realistic figure for a shareholder who owns, say, 1,000 shares of JPMorgan Chase & Co. common selling at 35. However, it does not follow that 35 represents a realistic value for the entire JPMorgan Chase common shares outstanding. There is no way other than in a merger or acquisition that all the JPMorgan Chase shares can be sold on the market for 35 a share or any other price. Thus, statements about an individual's present worth, obtained by multiplying his holdings by the quoted market value of his stock, have limited operational meaning in many contexts. Market mathematicians may multiply numbers together, but frequently there is a difference between what the numbers are and what they mean.

OUTSIDERS, INSIDERS, AND MARKET PRICE

Indeed, for most investors, market performance as an element in measuring true investment results should have a weight of less than 100 percent. An outsider holding a completely marketable security of a company with a perpetual life should give weight of close to zero to market performance whenever he knows or has reason to believe that the security's real worth is *not*

closely related to current market prices, and when he knows that he will neither need to liquidate in the near future nor to use the security owned as collateral for borrowings.

There is a school of thought that seems to hold that outside investors with that degree of certainty about investments in companies over which they have no control are bound to be unsuccessful—that the real world just never justifies so much confidence in a security. We disagree.

EXAMPLE

It appears that many of the most successful outside investments have resulted from having such confidence, whether it was by buying and holding General Motors common through the 1933 decline, or by acquiring Japanese insurance stocks at the depth of that country's extremely sharp business recession and stock market crash of 1965, or even by buying such Japanese securities in 1970 after they had doubled, or Xerox and Holiday Inn when they were emerging securities, or Chicago Northwest Railway and Berkshire Hathaway when they were workout situations, or deep-discount, high-yield, medium-grade bonds in 1974, or Apple Computer when Steve Jobs resumed leadership of the company in 1997.

For insiders and quasi-insiders, as their security holdings become less marketable because of restrictions on sale or otherwise, and as they attain positions in which they can exercise control over a corporation's affairs, market price tends to become less important than the fundamentals of the business. The purchasers of F. & M. Schaefer Corporation "restricted" common in 1968 at \$1 per share (see Chapter 27) did have an interest in the market price of Schaefer common stock after the company went public, and many obviously had to be pleased when the market price climbed to 59 in 1970. Yet what was happening to the business was far more important to them. For them, the key factor in 1970 was not the outstanding market performance of the common stock, but evidence of sluggish corporate performance because of competition from national beer brands. The high price of Schaefer stock would have been useful to these bargain purchasers in a nonpsychological sense only if they could realize something based on those prices by selling their stock, even at a discount from market (they did not and most could not), or if Schaefer Corporation used the high price to issue more equity securities, either to get cash into the company or to acquire earnings properties.

PROFESSIONAL MONEY MANAGERS AND BEATING THE MARKET

Certain economists believe strongly that the goal of professional money managers is to beat the

market.⁴ If professional money managers fail to beat the market either individually or en masse, this is taken as evidence that they are useless. Indeed, it is stated that the outside investor does best by investing only in Index Funds or Index exchange-traded funds (ETFs)—that is, unmanaged companies whose portfolios equal the Dow-Jones Industrial Average or Standard and Poor's 500 Stock Index.

The kindest word we have for this point of view is that it is amateurish. First, it ought to be obvious that the vast majority of professional money managers have fiduciary obligations that require them to do much more than beat the market. Among those duties are maintenance of cash income and cash principal. Is it important that a strongly capitalized insurance company outperform the market even though its net investment income is increasing at a compounded rate of 10 percent a year and even though in no instance had interest payments been passed or dividends cut or omitted on any security in the company's portfolio? We think not. The prime goal of the insurance company's professional money manager is, of course, cash income, not market performance.

Many economists also go one step further and say that there is no need for Securities and Exchange Commission disclosures and other investor protections. This viewpoint fails to observe the obvious. By and large, securities markets in the United States have been healthier during the past 80 years that the SEC has been in existence than ever before. Also, financial analysis has become more important. Furthermore, the quality of securities has gone up, at least as measured by the ability of issuers to provide securities holders with cash returns, that is, payments of interest and dividends. Would this be the case if there were no professional money managers and no SEC? Who knows? Perhaps if the environment were what these economists recommend, the Dow Jones Industrials in mid-2012 would be closer to 5,000 than to 13,000. But if it were 5,000, the average portfolio of marketable securities would have a market performance about average—the same as now.

In summary, it is important to note that the importance to be given to market performance or total return varies from situation to situation. Sometimes total return is all-important to an outside investor; in other instances, it is hardly of any moment. Unfortunately, many scholars and jurists tend to give market performance the same weight for all investments that it deserves in trading situations—100 percent. This unthinking emphasis is particularly unfortunate, partly because it gives stock market prices an emphasis that almost no one operating a business agrees with, and partly because it seems to foster attempts to beat the market on a relatively continuous basis—something most outside investors will never be able to do.

PERSPECTIVE ON BAILOUTS AND THE SIGNIFICANCE OF MARKET PERFORMANCE

In a meaningful sense, everyone who invests in a security seeks a return, or bailout, on that investment. Most of the time, *bailout* refers to the realization of cash benefits, but this is not so in one case—when ownership of a security results in obtaining various benefits associated with control of companies. Bailouts take many forms, only one of which is an ability to sell, or marketability. Insofar as other forms of bailout are unavailable, marketability and therefore market performance become increasingly important. And insofar as alternative bailouts are available, the significance of market performance diminishes. These other forms of bailout, which have already been discussed in Chapter 4, encompass cash payments to securities holders by the issuer itself.

Holders of debt instruments have a contractual right to receive periodic interest income and eventual return of principal; therefore, cash bailouts tend to be far more assured for them than for holders of common stocks. Accordingly, marketability tends to be significantly less important for a bond than for a common stock. Indeed, most long-term debt instruments, such as many of the tax-

free obligations of municipalities, private placements held by life insurance companies, and most mortgage loans held by various types of institutional investors, are probably not marketable at all. This difference in the significance of marketability between debt and equity is even recognized in certain regulatory areas: insurance regulations require that debt holdings that are not available for sale be carried on the company's books for statutory purposes at amortized cost, whereas common stocks are usually carried at market.

Insofar as common stock ownership represents control, the importance of market performance and marketability tends to be diminished significantly. Control usually allows for two types of bailouts: first, cash bailouts through the ability to control dividend policy and to obtain salaries and fees; and second, nonmonetary bailouts through the ability of controllers to create for themselves one or more benefits that can be described as part of the three Ps—power, prestige, and perquisites.

In addition, there are many stockholders who buy dividend-paying stocks and whose primary objective is income. As a matter of fact, many hold utility common stocks on the theory that present dividend rates are safe and indeed are likely to be increased periodically. To these holders, market bailouts are not important, and they view their holdings in much the same way as do holders of debt instruments, with the essential difference that such common stockholders perceive themselves as holding a “bond” on which “interest” payments are to be increased periodically. To such holders, market performance tends to be a minor consideration.

In contrast, there are security holders for whom market price tends to assume paramount importance, because market is where such holders are seeking their bailouts. These types of security holders fall into four general categories. The first is the common stockholder holding minority interests in which dividend income is either insignificant or not part of the holder's investment objectives. The second type is the control stockholder and company seeking to sell securities or to issue them in merger and acquisition transactions. Third is the holder who does not have a strong financial position, especially the outside investor or trader who has borrowed or intends to borrow heavily to finance his portfolio. The fourth is the not very well informed trader who makes decisions based on technical market factors rather than underlying knowledge about a company and the securities it issues.

SUMMARY

There is a common belief among many stockholders, lawyers, and much of the judiciary that stock market prices are the one realistic measure of value, and that the only way to tell how an investor is doing is by valuing his securities portfolio from time to time, even daily, based on stock market prices. Common sense tells us that this approach heavily distorts the facts of life because market prices are considerably less important to some security holders and some companies than they are to others. Market performance as a gauge of how an investor is doing deserves 100 percent weight when: the particular investor does not know anything about the company in which he is investing, when the investor's financial and/or personal position is such that he is vitally affected, or he believes he is vitally affected, by short-term market fluctuations, for sudden death securities; that is, issues where at a certain date, key events will occur as when an option expires, a tender offer concludes, or a merger transaction is consummated. In most other cases market performance deserves less than a 100 percent weight. Factors affecting how much weight to attach to market performance include the character of the portfolio of securities, whether one looks at the performance of a portfolio or an individual security, who the holder of the security is and what types of bailouts the holder of the security has available.

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¹ *Weinberger vs. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

² For example, see G. M. Loeb, *The Battle for Investment Survival* (New York: Simon & Schuster, 1965), p. 57: ‘Losses must always be ‘cut.’ They must be cut quickly long before they become of any financial consequence. . . . Cutting losses is the one and only *rule* of the markets that can be taught with the assurance that it is always the correct thing to do.’

³ The approach is covered in Chapter 15.

⁴ Myron Scholes, “Professional Measurement—Past, Present and Future,” *Evaluation and Management of Investment Performance* (Charlottesville, VA: The Financial Analysts Research Foundation, 1977).

CHAPTER 13

How Much Diversification?

[Portfolio Diversification versus Securities Concentration](#)

[Corporate Diversification versus Concentration](#)

[Summary](#)

The concept of diversification as a hedge against unsystematic risk is a central tenet of efficient portfolio theory (EPT) and is part and parcel of the capital asset pricing model (CAPM) and the more modern arbitrage pricing theory (APT). *Unsystematic risk* is only a fancy term to describe the risk of loss from trading or holding a security that arises from the market participant's:

1. Ignorance about the fundamentals of the business
2. Lack of control or elements of control over the business of the issuer in whose securities the market participant makes financial commitments
3. Lack of understanding of the substantive characteristics of the securities in which commitments are made
4. Lack of outside super-attractive access to financing (preferably nonrecourse)
5. Lack of price consciousness

If you are an outside passive minority investor (OPMI) that belongs to the above category of market participant, you better diversify to the fullest extent possible. If you believe in the efficient market hypothesis (EMH) and believe that universal equilibrium pricing exists, then you ought to diversify. The EMH is addressed to those who study securities market prices and have no detailed knowledge about corporations, to non-control OPMIs, and to people who utterly lack price consciousness because they assume that the OPMI market price is an equilibrium price with universal applicability.

Conversely, for market participants following a fundamental finance approach, whether the investor should concentrate or diversify will depend on:

1. How much knowledge about the fundamentals of the business of the issuer and its securities the investor has.
2. How much control or elements of control over the business the investor has.
3. How much access to outside finance (preferably nonrecourse) or access to capital on super-attractive terms the investor has.
4. How much bargain pricing the investor can obtain.

Like the concept of investing, which is best understood when contrasted with the concept of

speculation, the concept of diversification can also be better understood when contrasted with the concept of concentration.

PORTFOLIO DIVERSIFICATION VERSUS SECURITIES CONCENTRATION

It is logical where measures of risk are based on the quality of the issuer that portfolios of such securities be diversified, providing added protection to compensate for lack of knowledge about individual securities. In contrast, the investor who, because of know-how or control, has confidence in an equity investment based on price of the issue, and who has a financial position that will allow him to survive the short term, does not need the extra protection that comes from diversification. Such protection comes from a lack of encumbrances upon the investor. He stands to gain most from concentrating his investment in the area where his knowledge (and perhaps control) tips the risk-reward ratio for the particular security very strongly in his favor.

A simple framework that illustrates this point and that also provides a means for calculating the degree of diversification or concentration needed to achieve the maximum growth rate of investment capital over time was developed by John L. Kelly Jr. in 1956.¹ Although developed to address a different problem, what is known as the Kelly formula can be used to determine the size of a series of investment commitments relative to available investment capital that will yield the maximum growth rate of capital over time.

The Kelly formula is presented below:

$$f = \frac{p(b+1) - 1}{b}$$

where:

f is the fraction of current capital to commit to a particular investment to maximize compounded returns over time.

p is the probability of making money on the particular investment within an established time period.

b represents the odds or win/loss ratio for the investment.

Since f represents the fraction of available current capital that must be devoted to a particular investment commitment, it is the equivalent of a portfolio weight. A large portfolio weight means a concentrated portfolio since the total number of investments taking up all available capital will be the reciprocal of f . For example, an f of 0.25 would mean that the investor should commit 25 percent of his or her investment capital to that particular investment. An investor following the Kelly rule will have only four such investments in his or her portfolio (i.e., $1/f$ or $1/0.25$).

Let us now use the Kelly formula to illustrate the issues that we have discussed before. We start with an OPMI that believes in the EMH and universal equilibrium pricing, lacks knowledge of the fundamentals of the business, lacks control, is price unconscious, and is likely to have very small odds of making money on any single security selection. We characterize this particular OPMI as having odds of 50.5/49.5 or 1.0202, and an even chance of either picking a winning security or a losing one; that is, $p:1/2$. Using these two numbers in the Kelly formula yields $f = 0.01$. Faced with these odds resulting from no skills in business analysis and security selection, this particular OPMI should only commit 1 percent of his or her investment capital to any single security. If the investor were to invest all of his or her capital in similar securities, his or her portfolio should contain 100 securities; that is, a widely diversified portfolio.

Take an investor following the fundamental finance approach, with excellent knowledge about the fundamentals of the businesses he or she invests in, possessing the discipline to only buy securities at prices representing meaningful discounts from readily ascertainable net asset values,

but lacking control or access to super-attractive finance. Being price conscious and having knowledge about the business improves this investor's odds. In this case, the odds on any single security purchase are more likely to be 52/48 or 1.08, and the probability of selecting the winning issuers and securities accurately is $p:0.52$. Using the Kelly formula with these realistic values yields $f = 0.0769$ suggesting that the investor should commit almost 8 percent of its investment capital to any individual security so selected. Were the investor to invest all his or her available capital, the portfolio would contain only 13 securities.

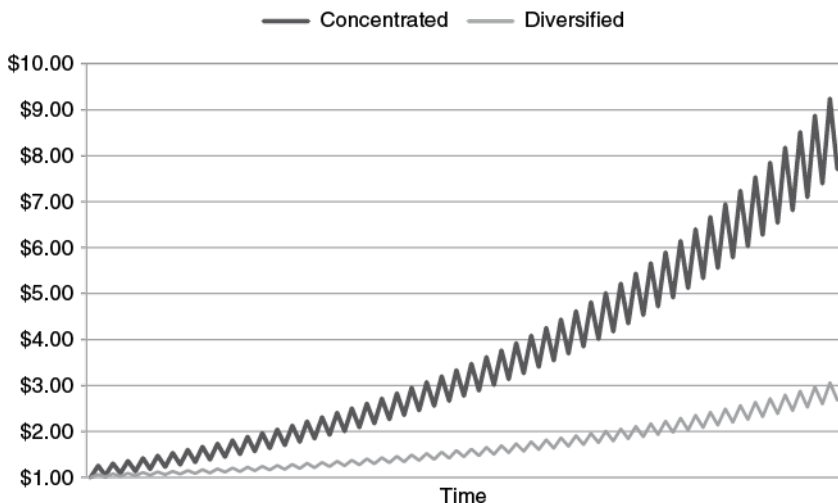
Finally, we look at an investor possessing control and access to attractive finance (say, an LBO sponsor) for whom the odds on his or her investments are more likely to be 60/40 or 1.5, and for whom the probability of picking these winning investments is $p:0.70$ since sponsors are afforded the possibility of conducting extensive due diligence on the companies they invest in. The Kelly formula for the case of a leveraged buyout (LBO) sponsor yields $f = 0.5$, that is, the sponsor should commit 50 percent of its available capital to any such identified opportunity. Were the LBO sponsor to invest all of its currently available capital it would have two deals in its current portfolio.

We have simply shown that investors wishing to grow their capital over time at high rates should choose their diversification level based on the criteria that we have outlined. These examples serve to remind the reader that diversification is a surrogate, and usually a damn poor surrogate, for knowledge, control and price consciousness.

The Kelly formula is also very useful in helping us understand the importance of the right amount of concentration or diversification on both the ultimate performance and the lumpiness or volatility of such performance. One of the arguments used to support the validity of the EMH is that it is impossible to beat market averages consistently, that is, most of the time. We have argued elsewhere that the true test of superior performance is total return over long time periods and not whether a market average is beat consistently. In fact, we can use the Kelly formula to show that the performance of a manager using the right amount of concentration will be superior over the long term but very lumpy and volatile during any specific, relatively short period of time chosen. By the same token, a manager that may be restricted in the amount of concentration used (say because the manager is a registered investment company (RIC) and must abide by strict diversification rules) could significantly underperform relative to what his/her investment approach could yield over long time periods if the right amount of concentration is used. In [Figure 13.1](#) we present the results of an investment operation having a win/loss ratio of 1.5 where the probability p of finding winning investments is $\frac{1}{2}$. Using these assumptions in the Kelly formula yields an $f = 0.1667$, which would lead to a highly concentrated portfolio of only six investments. The performance of this investment operation shown as the growth of capital over time is labeled "concentrated" on Figure 13.1. We also graph the performance of a portfolio that is built using the same approach to investment selection but over-diversifies four times more than the concentrated portfolio.

Figure 13.1 tells the story. Two facts stand out from this exercise: (1) the performance of the concentrated portfolio is far superior than the one corresponding to the overdiversified one, and (2) the concentrated portfolio performance is quite a bit more volatile than the overdiversified one over any arbitrary time window.

Figure 13.1 Growth in Capital and Performance Lumpiness When Following the Optimal Concentration Rule versus the Diversified Rule



An investment operation can be reduced to the problem of forming a portfolio of investments. The two issues in forming a portfolio are:

1. What to include in it (security and business analysis).
2. How much of the available capital should be committed to each particular investment (concentration versus diversification).

In this book we address the first issue. The Kelly framework highlights the substantive importance of the second one. As is almost always the case, conventional wisdom is rather misleading on the topic of diversification. For those investors following a fundamental finance approach to investing, too much diversification can mightily detract from performance. Concentration and lumpiness in performance are to be expected from following the right investment approach. For those OPMIs lacking knowledge, control, and being price unconscious, (i.e. the market participant that EMH and MCT address) substantial amounts of diversification must be used. Specifically, we believe that a common stock portfolio consisting of investments in companies enjoying strong financial positions, priced at a relatively large discounts from readily ascertainable net asset value (NAV), where the market participant has available comprehensive disclosures, should be relatively more concentrated and relatively less diversified. We feel comfortable insofar as at least 50 percent of a common stock portfolio consists of issues issued by companies where: the company enjoys a super strong financial position; the common stock is priced at, at least, a 20 percent discount from readily ascertainable NAV; disclosures are comprehensive; the common stock is traded in well regulated markets, and the prospects appear good that over the next three to seven years, NAV will grow by not less than 10 percent compounded annually after adding dividends.

CORPORATE DIVERSIFICATION VERSUS CONCENTRATION

Corporate diversification can be viewed as a contributory reason for acquiring an equity as well as for not acquiring one. Certain managements in certain situations seem to do extremely well by having a singleness of purpose—that is, by pouring all their resources into one industry. McDonald's is a good example of a highly successful, primarily single-purpose business. Other

companies that have concentrated on one line of endeavor seem to have suffered mightily for having done so. Companies in the cement and steel industries provide examples of businesses that might have fared much better had they diversified. Correspondingly, certain companies have been highly successful because of aggressive diversification into other businesses and industries. Examples include such diverse businesses as Cheung Kong Holdings and Brookfield Asset Management. But attempts at diversification have been anywhere from unsatisfactory to disastrous for such others as Boise Cascade, Beck Industries, Commonwealth United, Litton Industries, and Time Warner.

There is no *a priori* way for concluding that corporate diversification is *per se* good or bad. As we discussed in the previous section using the Kelly framework, diversification usually requires a high order of managerial ability, in operations as well as in investing. Many authorities apparently believe that concentration on diversification was a prime cause of the Penn Central bankruptcy. The facts are that the Penn Central management had some degree of success as investors on behalf of the railroad; they apparently were abominable at operating a railroad. The contribution of cash to the railroad operations generated by Penn Central's investments kept the business alive longer than otherwise would have been the case. The theory that the Penn Central management would have been better railroad operators had they not concentrated so much on investments may have some validity.

SUMMARY

How much diversification should be used in the construction of investment portfolios? It depends. If you believe in the EMH and in universal equilibrium pricing, then you should diversify. For the fundamental finance investor, however, diversification is a damn poor surrogate for knowledge, control, and price consciousness. Fundamental finance investors' portfolios will tend to be concentrated rather than diversified. We use the Kelly formula to illustrate why this should be the case.

¹ John L. Kelly, Jr., "A New Interpretation of Information Rate," *Bell System Technical Journal* 35 (1956): 917–926.

CHAPTER 14

Toward a General Theory of Market Efficiency*

The Determinants of Market Efficiency

External Forces Influencing Markets Explained

Great Economists Can Learn a Lot from Value Investors

Markets Where External Disciplines Seem to Be Lacking

Market Efficiency and Fair Prices in Takeovers

Summary

The worst misconceptions about dealing in corporate finance are promulgated by the academic literature on the subject. One such misconception is the definition of a market. Most academicians seem to define a market as the New York Stock Exchange, NASDAQ, or some other forum populated by outside passive minority investors (OPMIs). For the purposes of our discussion it is helpful to provide a general definition of a market:

A market is any financial or commercial arena where participants reach agreement as to price and other terms, which each participant believes are the best reasonably achievable under the circumstances.

Myriad markets exist and include the following:

- OPMI markets such as the New York Stock Exchange, NASDAQ, and the various commodity and option exchanges.
- Markets for control of companies.
- Markets for consensual reorganization plans in Chapter 11.
- Institutional creditor markets.
- Markets for executive compensation.

For the past 50 years, financial academics have mostly operated on the assumption that financial markets are highly efficient. In a highly efficient market, the price of a common stock multiplied by the amount of shares outstanding reflects the underlying equity value of the company issuing that common stock. This is embodied in the efficient market hypothesis (EMH). Recently, behaviorists have challenged EMH based on the theory that investors sometimes make emotional, irrational, and stupid decisions. But even behaviorists seem to concede that if investors were rational, financial markets would be highly efficient. We disagree. Certain markets will always be inefficient versus EMH standards of efficiency.

A basic problem faced by financial academics, whether efficient market theorists or behaviorists, is that they are strictly top-down—studying economies, markets, and prices, not the underlying bottom-up fundamentals that really determine what a business might be worth and what are the substantive characteristics of the securities issued by that business.¹ Put simply, the academics are best described as chartist-technicians with PhDs. Insofar as academics try to be

value investors, they seem to believe to a man (or woman) that value is measured only by predictions of future discounted cash flows (DCF). They don't grasp the fact that most firms and market participants have an overriding interest in wealth creation, not DCF, and DCF is only one of several paths usable to create wealth.

In bottom-up analysis, conclusions are drawn based on detailed analyses of individual situations—securities, commodities, companies—to ascertain whether gross mispricing exists or persists. As a general rule, such mispricings can arise out of one or more wealth-creation factors that are sometimes interrelated:

- Free cash flows from operations.
- Earnings, defined as creating wealth while consuming cash. For most firms (and governments), earnings can have long-term value only insofar as they are combined with reasonable access to capital markets.
- Asset and/or liability redeployments via mergers and acquisitions (M&A), contests for control, asset redeployments, refinancings, capital restructurings, spin-offs, and/or liquidations.
- Access to capital markets on a super-attractive basis such as selling common stock issues into a superheated initial public offering (IPO) market (e.g., the 2012 Facebook IPO) or having access to long-term, nonrecourse debt financing at ultralow interest rates (e.g., financing 80 percent of the cost of a Class A building, fully occupied under long-term leases entered into by creditworthy tenants).

Markets run an efficiency gamut. Some markets tend toward instantaneous efficiency, thereby comporting with the standards that are the essence of the EMH. Other markets tend toward a long-term efficiency but may never actually reach EMH efficiency. As a subset of this, it should be noted that a price efficiency in one market, say the OPMI market, is usually, *per se*, a price inefficiency in another market, say the takeover market. Some markets are inherently inefficient. Or to put it in another context, an efficient market in these situations means that certain market participants are virtually assured of earning very substantial excess returns on a relatively continual basis.

THE DETERMINANTS OF MARKET EFFICIENCY

Four characteristics determine whether a market will tend toward EMH-like instantaneous efficiency on the one hand or it will tend to be inherently inefficient by EMH standards on the other hand, or something in between.

Characteristic I: Market Participant

Insofar as the market participant is unsophisticated about value analysis, financed with borrowed money, and lacks inside information, that participant will face a market tending strongly to instantaneous, EMH-like efficiency. Insofar as an investor is well trained, well informed, and not influenced by day-to-day or short-run price fluctuations, that investor avoids being subject to an EMH-like efficiency.

Characteristic II: Complexity

How complex, or simple, is the security or other asset that is the object of the market participant's interest? Insofar as the security is simple (i.e., it can be analyzed by reference to a very few computer-programmable variables), the asset pricing will reflect a strong tendency toward instantaneous, EMH-like efficiency. A further condition for EMH-like efficiency is that there be a precise ending date, such as when indebtedness matures, options expire, or a merger transaction is consummated. EMH-like efficiencies cannot exist if one concentrates on analyzing the common stock of a going concern with a perpetual life, or if one analyzes a troubled debt issue that will participate in a reorganization and the timing on the completion of such reorganization is relatively unknowable.

Insofar as specific securities are concerned, three types of issues tend to be characterized by instantaneous, EMH-like efficiencies:

1. Credit instruments without credit risk (e.g., U.S. Treasuries).
2. Exchange-traded derivatives, including options, warrants, and convertibles.
3. Risk arbitrage—that is, situations where there are relatively determinate workouts in relatively determinate periods of time, as, for example, tend to exist after merger transactions are announced publicly.

Insofar as the analysis of the security entails complexity, EMH-type efficiencies tend to become unimportant factors.

Characteristic III: Time Horizons

If the participant is an OPMI involved in day-to-day trading, that participant will, in all probability, be faced with EMH-like efficiencies. If, however, the participant is a manager of a well-financed company and has a five-year time horizon during which time the company might choose to access capital markets (credit markets or equity markets), that participant will be involved in a market that is inherently inefficient by EMH standards. The manager who can control timing of when to access capital markets over a five-year period knows that there will be times when credit markets are very attractive for the company (i.e., interest rates are ultralow), and there will be times when it will be ultra-attractive to issue new equity in public offerings and/or mergers (i.e., an IPO boom).

EMH efficiencies exist only for participants in outside passive non-control markets who are heavily involved in daily, and even hourly, price movements of securities. The basic EMH concept is that market prices at any time reflect equilibrium. The old equilibrium changes to a new equilibrium only as a market absorbs new information. Thus, even securities that are analyzable by reference to a few computer-programmable variables are not priced efficiently if those securities lack very early termination dates. No EMH efficiencies can exist for investors with a long-term time horizon.

Again, in an efficient market, market prices determine the value of the company for all purposes. It is as William F. Sharpe, a Nobel laureate and a typical efficient market believer, stated in his book *Investments*: that if you can assume an efficient market, “every security price equals its investment value at all times.”²

Where there are no reasonably determinate termination dates, markets for securities can be grossly inefficient even though the analysis is simple and few variables are involved. A good example of this revolves around the common stocks selling at huge discounts from net asset value (NAV) of companies that are extremely well capitalized, highly profitable, and with glowing long-term records of increasing earnings, increasing dividends, and increasing NAVs. The principal assets of these simple-to-analyze companies consist of private equity investments, marketable securities, and/or Class A income-producing real estate. The market data in [Table 14.1](#) are as of July 6, 2012.

Table 14.1 Simple-to-Analyze, Extremely Well-Capitalized, and Highly Profitable Companies Selling at Discounts from NAV

Issuer	U.S. Dollar Price 7/6/12	Per Share Latest Reporting Date NAV	NAV Discount from Market
Henderson Land Development Group	\$5.86	\$10.09	42%
Investor AB	\$18.41	\$29.37	37%
The Wharf Holdings	\$5.84	\$8.65	32%
Wheelock & Co.	\$4.15	\$7.78	47%

The same analysis was pertinent for certain distressed securities on September 30, 2008, albeit that analysis was not as simple as that which exists for the high-quality common stocks cited in Table 14.1. The authors' analyses indicated strongly that the probabilities were that General Motors Acceptance Corporation (GMAC) senior unsecured loans were likely to remain performing loans. If not, upon reorganization or rehabilitation, the holder of these obligations likely would receive the common stock of, by then, a well-capitalized finance company or bank holding company.

GMAC notes due in 15 months were selling at 60, at a current yield of 13 percent and a yield to maturity of 55 percent. In the case of GMAC notes, it is important to mention that market price is unimportant for a holder who has not borrowed money to carry the securities. To earn excess returns here, all the analyst has to do is be right that the great weight of probabilities is that the notes would remain performing loans.

Characteristic IV: External Forces

How powerful are the external forces seeking to impose disciplines on the market participants and on the companies that are securities' issuers? Insofar as the external forces are very powerful, prices will tend toward EMH-like instantaneous efficiencies. Competition among market participants, such as exists on the floor of the New York Stock Exchange or on NASDAQ, represents powerful external forces imposing restraints on OPMI day traders so that their returns will likely reflect EMH-like efficiencies. Insofar as the external forces are weak, markets will be inherently inefficient. Boards of directors are an external force imposing discipline on the compensation of top management executives. Boards tend to be weak, and thus corporate executives tend to earn excess returns consistently. Indeed, when external forces are weak, certain market participants (not only corporate executives) will earn excess returns consistently. This is part and parcel of the definition of a market where each participant strives to achieve the best returns reasonably achievable under the circumstances.

EXTERNAL FORCES INFLUENCING MARKETS EXPLAINED

Markets and market participants are very much influenced by external forces that impose disciplines on stockholders, companies, and management. The principal ones are:

- Competitive markets
- Regulatory agencies
- Governments

- Financial Industry Regulatory Authority (FINRA), a self-regulatory organization
- Tax system
- Creditors
- Control stockholders
- Boards of directors
- Rating agencies
- Communities
- Labor unions
- Plaintiffs' bar
- Federal and state courts
- Passive stockholders
- Auditors
- Corporate attorneys

When external forces impose very strict disciplines (e.g., government regulators, senior creditors, credit-rating agencies, and the plaintiffs' bar), such strict regulation or control tends to stifle innovation and productivity. It is important to note that government does not have a monopoly on actions that stifle innovation and productivity. The same disease exists in the private sector, where, say, financial institutions follow overly strict lending practices.

When external forces impose little or no discipline (e.g., boards of directors rubber-stamping top management compensation and entrenchment packages or passive shareholders' proxy votes), there tends to be created an environment that will be characterized by corporate inefficiency, frauds, and a gross misallocation of resources.

Who can deny that there is a need for balance in the imposition of disciplines? They should be neither too strict nor too soft. There is a school of thought stating that government regulation is *ipso facto* nonproductive and that private sector regulation is *ipso facto* productive (except for the plaintiffs' bar). Nothing could be further from reality than such beliefs.

GREAT ECONOMISTS CAN LEARN A LOT FROM VALUE INVESTORS

After reading three volumes authored by great economists—*The General Theory of Employment, Interest and Money* (originally published in 1936, reprinted in 2011 by CreateSpace) by John Maynard Keynes, *The Road to Serfdom* (originally published in 1944, reprinted in 2007 by University of Chicago Press) by F. A. Hayek, and *Capitalism and Freedom* (originally published in 1962, reprinted in 2002 by University of Chicago Press) by Milton Friedman—one comes away with the impression that each was observing the earth with his naked eyes from 80,000 feet up. They missed a lot of details that are part and parcel of every value investor's daily life.

To begin with, the three seem to recognize only three major forces directing the economy: capital (private owners, managers, or entrepreneurs), labor, and government. In fact, there are myriad other nongovernmental forces directing any industrial economy, including, among others, management control persons (separate and apart from private owners); creditors; rating agencies; boards of directors; professionals, especially attorneys and accountants; trade associations; and self-regulatory organizations such as FINRA.

For the three great economists, governments perform four functions: control the economy; regulate sectors of the economy; set fiscal policies (budget surpluses or deficits); and set monetary policies (interest rates and the quantity of money). In the twenty-first century, it seems a lot more productive in determining how the nation's resources are to be allocated by the private sector to look at governments as engaged also in the following activities:

1. Be a regulator.
2. Levy and collect taxes, with both tax rates and the specific methods of taxation being important.
3. Provide credit.
4. Provide credit enhancements.
5. Provide insurance.
6. Provide subsidies.
7. Provide infrastructure frameworks, physical and procedural, including having reliable judicial systems.
8. Be a customer.
9. Be a competitor.
10. Provide public protection via the military, police and other.

F. A. Hayek wrote *The Road to Serfdom* in the 1940s. The book was relevant for its time. The gravamen of its arguments was that command economies without a private sector, such as the Soviet Union then (and North Korea and Cuba today), just do not work. They deny their populaces not only economic well-being but also freedom. Of course, Professor Hayek was 100 percent right about this. However, in no way does it follow, as many Hayek disciples seem to believe, that government is, *per se*, bad and unproductive while the private sector is, *per se*, good and productive. In well-run industrial economies, there is a marriage between government and the private sector, each benefiting from the other. Since World War II, there have been a significant number of large command economies that have worked well by utilizing an incentivized private sector. Such economies include Japan after World War II, Singapore and the other Asian Tigers, Sweden, and China today.

For the value investor, the issue is not government versus the private sector. Rather, it is that, in accordance with Adam Smith's invisible hand, those in control, whoever they are, should be incentivized appropriately. Government has a necessary role in determining how control persons are incentivized; and where the private sector will allocate resources in accordance with the invisible hand so that private control persons can maximize wealth for themselves, and also, by indirection, their constituents who are usually the owners of private enterprises. Whether one likes it or not, how and where Adam Smith's invisible hand allocates resources through actions by private enterprises will be determined in large part by what government actions are. Should these government reactions be random, or at least in small part a product of planning? In the United States today it seems as if the federal government directs resources mostly by who has political clout. There is no question but that private enterprise, in its actions, is particularly sensitive to what the federal government does in terms of:

- Tax policy, both quantitatively and qualitatively
- Credit granting and credit enhancing

Control persons in the U.S. private sector are extremely sensitive to, and react very efficiently to, government policies in terms of taxation and in terms of credit granting and credit enhancing. Put in Milton Friedman's context, Adam Smith's invisible hand turns out to be more than random. It will be directed, at least in great part, by the government's tax policies, and the government's credit-granting policies. Put otherwise, what government policies contribute is important to the private sector's determination of where the profits are.

Professor Hayek, however, seems to miss the opposite point that a free market situation is probably also doomed to failure if there exist control persons who are not subject to external disciplines imposed by various forces over and above competition: governmental, quasi-governmental and private sector. This is probably truer for financial markets than it is for commercial markets, but the point seems valid for both markets. Put simply:

Competition by itself tends not to be a strong enough external discipline to make markets efficient.

Where control persons are not subject to meaningful external disciplines, the following seems

to occur:

- Exorbitant levels of executive compensation, a shortcoming rampant in the United States today
- Poorly financed businesses with strong prospects for money defaults on credit instruments, e.g., look at the insolvencies in recent years of Enron, General Motors, Chrysler, Lehman Brothers, and others
- Speculative bubbles, for example, the 1998–2000 IPO boom, the 2008–2009 burst of the real estate bubble
- Tendency for industry competition to evolve into monopolies and oligopolies where the companies involved have a large degree of insulation from competitive forces
- Corruption: for example, Enron, WorldCom, Refco

It ought to be noted, too, that many highly competitive industries happen not to be subject to meaningful price competition. Two such industries are money management and investment banking. In the investment-banking arena, there seems to be a universal 7 percent gross spread involved in bringing most new issues public. Also, a principal disadvantage of investing in distressed securities revolves around the rip-off of prepetition creditors by professionals, mostly lawyers and investment bankers. Competition to obtain professional engagements is intense. But no professionals in the distressed world, with very minor exceptions, ever seem to compete on price.

Disciplines are imposed on control persons operating in free markets by many, many more entities than just governments and competitors. The great economists mostly fail to recognize the existence of these other forces imposing discipline. Some tend to be harsh disciplinarians—creditors and rating agencies; and some seem to be very weak disciplinarians—passive owners of common stocks and boards of directors. These other forces imposing disciplines on control persons include the following:

- Owners
- Boards of directors
- Creditors—especially banks
- Rating agencies
- Labor unions
- Trade associations
- Communities
- Auditors
- Attorneys

Compared with value investors, great economists from Keynes to Modigliani and Miller seem largely oblivious to the very important role creditworthiness plays in any industrial economy.

The monetary and regulatory authorities influenced by the great economists seemed focused only, before the 2008–2009 meltdown, on gross domestic product and the control of inflation-deflation. They did not appear to worry, much, if at all about creditworthiness. Creditworthiness should have been the third leg of their analytical stool along with GDP and the control of inflation. Post 2009, this no longer seems true. Creditworthiness is now a real worry. As far as we can tell in mid-2012, corporations, in general (perhaps excluding depository institutions), probably have never been more strongly financed. On the other hand, governments—federal, state, and local—and consumers probably have never been less creditworthy than they are now. The ongoing crisis in the Eurozone in 2012 seems to reflect an absence of any useful ideas by economists and political figures to bring creditworthiness to national sovereigns—Portugal, Italy, Ireland, Greece, and Spain. They do not seem to be even trying to create creditworthiness in the various rescue plans they are formulating.

Milton Friedman is gung-ho for free markets, unfettered by government intervention. As he states on page 22 of *Capitalism and Freedom*, “To the liberal, the appropriate means are free discussion and voluntary cooperation, which implies that any form of coercion is inappropriate.”

Professor Friedman also states on page 13, “Fundamentally, there are only two ways of coordinating the economic activities of millions. One is control direction involving the use of coercion—the technique of the army and the modern totalitarian state. The other is voluntary co-operation of individuals—the technique of the market place.”

Professor Friedman, unfortunately, seems to have no background, or experience, in corporate finance. If he did, he would understand that public corporations just would not work unless, in the relationship between control persons and owners, certain activities would encompass voluntary exchanges while other activities would encompass coercion. So it is also on the national and global levels.

Also, given a background in corporate finance, Professor Friedman would have understood that there are three general ways for coordinating the economic activities of millions, not two:

1. Central direction without the existence of a private sector.
2. Complete voluntary cooperation without the existence of many coercive external disciplinary forces, whether governmental or private, influencing the marketplace.
3. The real-world situation where governments and other external forces have an influence on, and frequently direct the activities that transpire in the marketplace. Indeed, the various marketplaces in the United States seem to be ultrasensitive to certain directions they get from governments through tax policies, credit granting, and regulation.

In public corporations, there are certain activities that are essentially voluntary and others that are essentially coercive from the point of view of noncontrol securities holders.

Voluntary activities, where each person makes his or her own decision whether to buy, sell, or hold, encompass open market trading activities, certain cash tender offers, private purchase and sale transactions, and most exchanges of securities, including the out-of-court restructuring of troubled companies.

Coercive activities, where each individual security holder is forced to go along with a transaction or event, provided that a requisite majority of other security holders so vote, encompass proxy voting for boards of directors; most merger and acquisition transactions including reverse splits and short form mergers; certain cash tender offers; calls of convertible bonds or preferred stocks; the reorganization of troubled companies under Chapter 11 of the Bankruptcy Act; and the liquidation of troubled companies under either Chapter 7 or Chapter 11 of the Bankruptcy Act.

We are as one with Professor Friedman that, other things being equal, it is far preferable to conduct economic activities through voluntary exchange relying on free markets rather than through coercion. But Corporate America would not work at all unless many activities continued to be coercive; security holders may get a right to vote (which vote may be *pro forma* and meaningless), but the security holders are coerced into going along whether they like it or not once a requisite vote has taken place. Incidentally, appraisal rights under state law, can be pretty meaningless in the scheme of things in merger and acquisitions, and can hardly be thought of as voluntary. Without some element of coercion, two undesirable things are bound to occur in a free market:

1. Adverse selection, i.e., individuals who believe they are benefited economically by a transaction go along, while those who believe otherwise opt out of the transaction. If this were permitted, there would be no mergers and no Chapter 11 reorganizations, something highly destructive to corporate well-being and the well-being of the general economy.
2. There would be unsolvable hold-out problems. For example, voluntary bond exchanges to make a company more creditworthy would frequently be doomed to failure because those who hold out know that because of

their hold-out, their bond position would be credit enhanced if most of the other bondholders exchange.

Assuming that the goal of an economy ought to be to maximize the average per capita income, and wealth, for its citizens (or residents), then adverse selection and hold-out problems have to be modified, in certain areas, reliance solely on voluntary exchanges or the free market. Specifically, there are areas where, because of adverse selection and hold-out problems, the United States should not rely wholly on market mechanisms. These areas include the following:

- **Medical Care:** There is one good measure of how well cared for a population is; to wit, the average age of death. Here, the United States performs worse than most industrial economies. This seems a shame because the very best medical care in the world exists in this country for those who can afford it. The country would be much healthier if all its residents had access to decent medical care without adverse selection opt-outs.
- **Social Security and Pension Plans:** Clearly, the adverse selection problem will loom large if these retirement mechanisms are made wholly, or almost wholly, voluntary.
- **Education:** This country seems to be falling behind much of the rest of the industrial world in elementary through high school education, even though the United States probably still has the best university system in the world. There seems to be a real problem between allowing all parents to pick the school that their children should attend and the problem of adverse selection. Tough choice; we don't have any easy answers.

Government regulation is not, *per se*, good or bad. There is good regulation and there is bad regulation. An example of good regulation is the Investment Company Act of 1940 as amended. An example of bad regulation is the Sarbanes-Oxley Act of 2002.

It ill behooves any successful money manager in the mutual fund industry to condemn the very strict regulation embodied in the Investment Company Act of 1940. Without strict regulation, we doubt that the industry would have grown as it has grown, and also be as prosperous as it is for money managers. Because of the existence of strict regulation, the outside investor knows that money managers can be trusted. Without that trust, the industry likely would not have grown the way it has grown. Outside investors know that the money managers cannot steal, cannot be involved in self-dealing, are limited in causing the fund to borrow money, fees charged are controlled, and the mutual fund must diversify as a practical matter. All of this occurs for the benefit of shareholders, while still permitting the money manager to prosper mightily from the receipt of management fees. This is an example of good, intelligent regulation. Messrs. Hayek and Friedman probably do not recognize the existence of such beneficial regulation.

On the other hand, Sarbanes-Oxley, or SOX, is an example of stupid, non-productive regulation. It seems to be regulation based on the belief that every company, every chief executive officer, and every chief financial officer, is associated with Enron, WorldCom, or Refco. Every company, therefore, should be subject to onerous regulation although such regulation does not seem to do anything, or much at all, about investor protection. The upshot of SOX is that it detracts mightily from the attractiveness of U.S. capital markets. No CEO or CFO likes being subject to liabilities that arise out of SOX. Smaller public companies cannot afford to comply with SOX. Few foreign companies are going to subject themselves to American jurisdiction unless they absolutely need access to American capital markets trading publicly owned securities. It is likely that Messrs. Friedman and Hayek believe most regulation is SOX-like. We do not. Some regulation is good; some bad. It's all case by case.

Put otherwise, actions or expenditures by governments are not necessarily unproductive, and actions or expenditures by the private sector are not necessarily productive. Actions and expenditures ought to be gauged for usefulness on a case by case basis.

MARKETS WHERE EXTERNAL DISCIPLINES SEEM TO BE LACKING

Merchant Bankers (Promoters of Leveraged Buyouts)

Normally, people who put their own money into deals are known as principals, and those people who put deals together for fees but who do not have their own money in the deal are known as brokers. Merchant bankers are often brokers masquerading as principals. They usually invest none—or very little—of their own money in the deal, but they both collect their fees for putting deals together and obtain an equity interest in deals without any—or any material—money investment. Merchant banking has become a main activity for such major Wall Street names as Kohlberg Kravis Roberts & Co.; Forstmann Little; Morgan Stanley; The Goldman Sachs Group, L.P.; and Citicorp Ventures.

Until the 1980s, principal broker-dealers, such as Goldman Sachs and Morgan Stanley, believed that their best use of capital—both human and financial—was to employ capital in their own broker-dealer activities rather than to become involved in owning non-broker-dealer equities on a permanent or semipermanent basis. This attitude no longer exists, and much capital is now employed in structuring LBOs so that the merchant banker becomes a permanent or semipermanent investor in a corporation in which the merchant banker has meaningful elements of control.

Merchant banking has become increasingly competitive in recent years. This is to be expected, given the tendency toward efficiency that seems to exist in all markets. As far as can be determined, however, most of the better merchant bankers continue to earn excess returns as deal promoters, in part because there is so much outside money, run by passivists, such as pension funds that are eager to participate in LBOs. Merchant bankers structure fees for such investors so that they receive compensation as hedge-fund operators.

A typical setup for merchant banking activities is a limited partnership, a form also used for hedge funds engaged in venture capital investing, arbitrage, distress, and trading activities. Although terms may vary, a usual relationship is that the promoter—the general partner (GP)—receives an annual management fee of 1 to 2 percent of funds committed plus a profit participation of 20 percent of gains, sometimes accrued or paid only after the limited partners (LPs) receive a preferred return of 6 to 10 percent. For most limited partnerships, the final terms are arrived at after negotiations with a lead investor. In powerful limited partnerships (e.g., Kohlberg Kravis Roberts), the GP tends to dictate the GP-LP arrangements. Sometimes the GP gets to keep for itself various benefits, such as deal fees, rather than turning them over to the partnership.

Hedge-Fund Operators

Normally, hedge-fund operators run limited partnerships as GPs. There cannot be more than 100 LPs if the business entity is to avoid becoming a registered investment company (RIC); also, the partnership cannot have more than 35 LPs if it is to avoid becoming a registered investment adviser (RIA). Compensation to GP usually follows the merchant banker model outlined above: an up-front continuous fee of 1 to 2 percent of assets managed per annum, plus a profit participation after the limited partnership has earned a *bogey* of, say, 6 to 10 percent per annum. Profit participation can range from 20 to 50 percent. Those who do such hedge-fund deals include:

- Merchant bankers–LBO promoters
- Risk arbitrageurs
- Vulture funds
- Venture capitalists

- Real estate syndicators
- Oil and gas syndicators
- Movie producers

There is probably some uniformity in the financial hedge-fund market revolving around 1 (a 1 percent annual management fee) and 20 (a 20 percent profit participation). Promoters' compensations may be different in nonfinancial areas:

- Before 1986, real estate limited partnerships had more like 3 to 5 percent management fees and 50 percent participation in profits plus property management fees. It seems that since the real estate tax-shelter (TS) debacles between 1986 and the early 1990s, promoters' compensation has gravitated more to the economic equivalent of 1 and 20, whether the real estate promoters are being compensated as GPs or as managers of real estate investment trusts (REITs).
- Oil and gas syndications used to have promoters' participations based on the concept of one third for one quarter: Put up 25 percent of the money invested for a 33 percent interest, plus management and operators' fees.
- There probably are norms for promoters' compensations in show business and movie deals, usually under the rubric of producer's compensation.

Governance of limited partnerships is almost always strictly in the hands of GPs. The norm is that LPs have fewer governance rights than exist for OPMI shareholders of corporations. This is especially true for publicly traded limited partnerships.

In raising funds, it is better from the promoter's point of view to raise funds for a blind pool: After funds are committed, the promoter can invest in whatever he or she chooses. This is not always possible, since many potential LPs want to invest only in specific deals.

The limited partnerships referred to here are private exempt from SEC registration under Regulation D because each has fewer than 35 investors. In the 1980s, publicly registered limited partnerships were common, especially in real estate and in oil and gas.³

Bailouts for LPs are varied. For example, the sales pitch for real estate tax shelters prior to the 1986 amendments to the Internal Revenue Code was that returns would be made up of tax losses, perhaps some cash income followed by sale at a terminal date, whereas for a venture-capital limited partnership, the bailout revolves around taking portfolio companies public at super prices in future initial public offerings (IPOs).

Investment Bankers

Investment bankers earn huge fees providing services in three areas:

1. Advisory, including fairness opinions, other valuations, financial strategies, and litigation support.
2. Merger and acquisition activities (i.e., business brokerage).
3. Distribution of securities through public underwritings and private placements.

Securities Salespeople

Since the advent of competitive commission rates in 1975, an increasing emphasis of Wall Street sales forces has been to offer exclusive products with large gross spreads rather than to emphasize

the purchase and sales of securities in secondary markets. For example, the fairly typical gross spread on the 1986 IPO of Boston Celtics, L.P. was \$1.29 per unit, which would compare with a commission in the secondary market charged a customer of, say, anywhere from 2 cents a unit, where the customer obtained a discount to a maximum of 40 cents per unit for 1,000 units acquired from a full-service nondiscounting broker-dealer. Of the \$1.29 gross spread, anywhere from one third to one half might have ended up as security salesperson's compensation. It seems that for some years, many security salespeople earned excess returns marketing exclusive products with large gross spreads, including real estate and oil and gas limited partnerships, load mutual funds, and IPOs. There are probably tremendous institutional pressures within the financial community to keep coming up with products that will continue to permit sales forces to earn excess returns. Not only are the commissions earned on IPOs large, but also most IPOs are designed to be easy sells in that at the time of initial offering, demand exceeds supply.

Money Management

Control of funds for basically passive investments is an inordinately profitable business with very little price competition, whether such control is through registered investment companies or registered investment advisers. There are three principal sources of excess returns when a firm has assets under management: sales load, management fees, and control of portfolio trading. In addition, those who control funds are in a position to deliver excess returns to other controllers, by, for example, appointing outside directors and choosing attorneys and accountants for funds.

There is a ready market for the sale of companies with funds under management at prices, which in 2011 ranged from 2 to 5 percent of funds managed. [Table 14.2](#) shows funds under management for selected participants.

Table 14.2 Funds Under Management for Selected Companies (As of the End of 2011—Approximate Figures)

Company	Billions of Dollars
BlackRock Global Investors	\$3,650
State Street Global Advisors	\$2,000
The Vanguard Group	\$1,700
Fidelity Investments	\$1,500
PIMCO	\$1,400
Dreyfus Corporation	\$1,260

Promoters in Trading Environments

A discussion of promoters in trading environments is more often the purview of those involved with academic finance and EMH rather than of value investors. Players earning excess returns persistently from trading activities include the following:

- Market makers
- Users of free or almost free credit balances at broker-dealers
- Certain spread lenders

There is confusion in the academic literature on whether excess returns are earned on sunk costs or present values. As a practical matter, stock exchange specialists can earn excess returns forever, as can the owners of television stations, because once they have the franchise to earn excess returns, no one is in a position to enter the market and cause entrenched players to give up their returns.

Top Corporate Managements

If boards of directors do not impose discipline on top managements' compensation, no other entity will. The steepest slope in the industrial world seems to be in the United States between the earnings of managements and those of employees.

Controlling management compensation is the province of boards of directors, but discipline imposed on management compensations by boards of public companies seems virtually nonexistent. *De facto*, board appointments are made by managements that are unlikely to appoint either people who are not friends or who are troublemakers. Delaware is the leading corporate state. There are virtually no cases in Delaware involving allegations of excessive management compensation. There is an Internal Revenue Service (IRS) rule denying corporate tax deductions for certain management compensation in excess of \$1 million per year per individual, but the rule is easily circumvented.

Top executive compensation has several components:

- Salaries
- Perks
- No-risk or low-risk equities, especially through stock options
- Certain transactions, including leasing properties to company or providing other services for compensation
- Participation in merchant banking activities, such as management buyouts (MBOs)
- The chance to employ friends and relatives
- The control of corporate governance, including management entrenchment

Other Professionals Who Tend to Enjoy Excess Returns

Other professionals can earn what seem to be excess returns:

- Defense attorneys
- Plaintiffs' attorneys (in the United States, the existence of class actions and absence of security for costs helps promote excess returns)
- Management consultants
- Tax advisors
- Bankruptcy attorneys

Other professionals who are probably less well compensated than investment bankers and attorneys include the following:

- Business brokers
- Appraisers
- Providers of litigation support (expert witnesses)

Two groups of professionals that provide truly essential services, yet seem to be grossly undercompensated are auditors and indenture trustees. Auditing has been a notoriously unprofitable profession in this country, given the legal developments in accountants' liability. With the prerequisite of independence, auditors are held to far higher standards than are other professionals, especially investment bankers and attorneys. Such high standards are essential. Without reliable audit standards, the U.S. economy probably would cease to function because it would probably be impossible to grant commercial credit.

Corporate Monopolies and Oligopolies

Many corporations—the Coca-Cola Company, Google, Apple Computer, Intel—earn superior returns consistently, relatively insulated from competition and other external forces that could impose disciplines.

MARKET EFFICIENCY AND FAIR PRICES IN TAKEOVERS

Fair is defined as that price, and other terms, that would be arrived at in a transaction between willing buyers and willing sellers, both with knowledge of the relevant facts and neither under any compulsion to act.

The problem is that in many transactions for companies whose common stocks are publicly traded, especially MBOs, the real world situation is one of willing buyer-coerced seller; where the buyer is also an agent who is supposed to represent the interests of the seller. The seller, whose interest is supposed to be represented by the buyer, is the public shareholder, or OPMI. The buyer, at least in part, is usually corporate management and/or control shareholders.

Coercion of OPMIs occurs in two ways:

1. In a merger, an OPMI is bound by the requisite vote (anywhere from 50 percent of those voting to two thirds of the outstanding shares) where the vote process is rigged in favor of management and/or others who control the proxy machinery and whose proxy solicitation is financed by the corporate treasury. It tends to be utterly impractical for OPMIs to dissent from transactions and then perfect their rights of appraisal, in the event that relevant state statutes even give OPMIs rights to seek an appraisal.
2. In tender offers (or occasionally other market purchases), OPMIs may face the threat of the company going *dark* in that the nontendering (or nonselling) OPMI common stockholder will be left owning a security for which there is no public market. Once dark, there may be no real market for the common, and there could be a lack of many securities law protections for the OPMI.

Therefore, the purpose of fairness opinions, and fairness in general, ought to be to simulate a willing buyer-willing seller environment even though there tends to be in the real world, a willing buyer-coerced seller environment. Many appraisals by investment banks, and others, do not recognize this, and market price often will be the principal determinant of the transaction price even where there is a willing buyer-coerced seller situation. Put otherwise, in rendering many fairness opinions, little or no consideration is given to the important question: What is the company worth to the buyer? For example, in Delaware, the leading corporate state, there are no appraisal rights for OPMIs in transactions involving an exchange of common stocks where both issues of common stock are publicly traded. Also in Delaware courts, fair value excludes consideration of values arising out of the merger itself; in effect, do not consider or weigh what the deal might be worth to the buyer.

What makes an OPMI a willing seller? A premium over market.

What makes a control person a willing buyer? A price that represents a discount from what the buyer thinks the business is really worth to him, or his institution.

Thus, EMH notwithstanding, there frequently is a huge gap between the price that would satisfy a willing seller and the price that would satisfy a willing buyer.

Given that OPIMs are willing sellers and control persons are willing buyers, it is logical to assume that most of the time there will be a wide disparity between what a willing seller will assume is a fair price and what a willing buyer will assume is a fair price. Each group tends to focus on different factors. The OPIM seller will tend to focus on those corporate variables most likely to affect near-term market prices, to wit, short-term outlooks for earnings, earnings before interest, taxes, depreciation, and amortization (EBITDA), dividends and industry identification. Control buyers, on the other hand, tend to focus on how they can finance the transaction, the quality and quantity of resources in a business, and long-term outlooks.

Obviously, takeover prices tend to be a lot more favorable for OPIMs when the price arrived at is the result of competitive bids rather than only negotiations between parties. A sale of assets under Section 363 in a Chapter 11 case is always a bidding contest where open bidding more or less assures a fair price. The problem for most healthy companies is that most corporate endeavors have to be negotiated—transactions are complex. Contracts for negotiated transactions almost always contain *no shop*, *break-up fee*, and *topping fee* clauses. These discourage the conversion of negotiated transactions into bidding contests.

The argument is made by OPIM representatives, including the Plaintiff's Bar, that in an MBO-type transaction, the control persons should be obligated to pay the OPIMs that price which represents what the business is actually worth to the buyer.

We disagree. If control persons were unable to buy businesses at prices that represent discounts for them, then buying interest by control persons would dry up.

SUMMARY

A market is any financial or commercial arena where participants reach agreement as to price and other terms, which each participant believes are the best reasonably achievable under the circumstances. Four factors determine whether a market will tend toward EMH-like instantaneous efficiency on the one hand or it will tend to be inherently inefficient by EMH standards on the other hand, or something in between. These factors are (1) who the market participant is; (2) how complex, or simple, is the security or other asset that is the object of the market participant's interest; (3) the time horizons of the participants; and (4) external forces imposing discipline on the participants. We review each of these factors and use them to highlight misleading simplifications that great economists have brought to bear in the conventional understanding of several economic problems. We also provide a list of examples of markets where external disciplines seem to be lacking, and illustrate our framework in the analysis of fair market prices in takeover transactions.

* This chapter is based on material in Chapter 7 of *Distress Investing: Principles and Technique* by Martin J. Whitman and Fernando Diz (© 2009 by Martin J. Whitman and Fernando Diz), and ideas contained in the 2005 4Q and 2007 1Q letters to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ These substantive characteristics of securities were discussed at length in Chapter 4 of this book.

² William F. Sharpe, *Investments*, 3rd ed. (Upper Saddle River, NJ: Prentice Hall, 1985), p. 67.

³ See the excellent book by Kurt Eichenwald, *Serpent on the Rock*, which was published in 1995 (New York: HarperCollins) and describes business practices at Prudential Bache Securities.

Part Two

Putting It All Together: Safe and Cheap Investing versus Conventional Approaches

CHAPTER 15

Safe and Cheap Investing*

The Safe and Cheap Approach

Benefits of the Safe and Cheap Approach for the OPMI

Restrictions and Demands of the Safe and Cheap Approach

Summary

It has been our observation that the most successful activists have had much the same approach to investing that the most sophisticated creditors have had toward lending. Essentially, these people approach a transaction with two attitudes, the first having to do with their order of priorities. In looking at a transaction, the single most important question seems to be: What have I got to lose? Only when it seems that investment risks can be controlled or minimized does the second question come up: How much can I make?

The second attitude has to do with a basic feeling that investment risk—how much one can lose—is essentially measured internally, not externally. The possibilities of unsatisfactory results from an investment or loan are to be found internally in the performance of the underlying business and the resources in the business, not externally in the market prices at which a company's securities might trade. Successful activists and creditors, while not unmindful of the *value messages* that are delivered by markets, tend not to be overly influenced by such messages. Their attitude is: As far as my objectives are concerned, I know much more about the situations in which I invest or in which I lend than the stock market does.

THE SAFE AND CHEAP APPROACH

A basic premise of this book is that many noncontrol investors ought to adopt the same standards of valuation that are used by successful activists, creditors, insiders, and owners of nonpublic businesses.

First and foremost, they must gauge the investment risk. Key variables for doing this are the financial position of the business being analyzed and/or the financial position of the securities holder. Businesses with strong financial positions are those that have access to enough liquid funds so that they can pay for whatever reasonable requirements they might have and still have access to a comfortable amount of surplus liquidity. Earnings, even accounting earnings, are, of course, frequently an important element in determining financial strength or creditworthiness, but this is a far cry from the position usually expounded—that for unaffiliated securities holders, earnings are the primary factor and, in fact, determine value.

Companies with strong financial positions tend to be less risky than those not as well situated. Furthermore, they tend to be more expandable because of their greater ability to obtain new funds.

These companies also are the most attractive candidates for resource conversion activities such as mergers and acquisitions, liquidations, share repurchases, takeovers, and other changes in control.

Our views as developed in this book are that attractive equity investments for outside passive minority investors (OPMIs) ought to have the following four essential characteristics:¹

1. The company ought to have a strong financial position, something that is measured both by the presence of quality assets and by the absence of significant encumbrances, whether a part of a balance sheet, disclosed in financial statement footnotes, or an element that is not disclosed at all in any part of financial statements. Strong financial positions or creditworthiness provide “insurance” to investors and opportunism to management. (Safety of the issuer)
2. The company ought to be run by reasonably honest management and control groups, especially in terms of how cognizant the insiders are of the interests of creditors and other security holders. The company must also operate in markets where regulators provide significant protections for minority investors. (Safety of the issuer and issue)
3. There ought to be available to the investor a reasonable amount of relevant information, although in every instance this will be something that is short of “full disclosure”—the impossible dream for any investigator, whether activist, creditor, insider, or outside investor. (Disclosures of enough quality to perform thorough appraisals of the safety of the issuer and issue)
4. The price at which the equity security can be bought ought to be below the investor’s reasonable estimate of net asset value (NAV). (Price of the issue)

These four elements are the *sine qua non* for an investment commitment using the safe and cheap approach, because their presence results in a minimization of investment risk. But they are not simply by their presence sufficient reasons for an investment commitment. The absence, however, of any one of them is reason enough to forgo any passive investment, regardless of how attractive it might appear based on other standards.

The environment within which an investor can search meaningfully for these four characteristics is a good one. The required disclosures under the securities laws give investors good insights into the first three characteristics. Audited financial statements, including footnotes, are particularly useful in describing and enumerating many of a concern’s encumbrances, albeit some potential encumbrances, such as necessary or desirable capital expenditures, may not be disclosed. Proxy-statement disclosures about management compensation and “certain transactions” with insiders, as well as narrative from Form 10-K and financial-statement footnote disclosures about litigation, aid in determining the degree of consideration insiders are likely to have for the interests of security holders. Business descriptions in annual reports, merger proxy statements, prospectuses, and 10-Ks have never been better in enabling investors to understand an enterprise.

In addition to the four essential characteristics, supplementary factors that can make an equity security attractive can be so varied as to defy anyone’s imagination. In fact, most of these factors in most analyses will exist in various combinations. To give the reader some insight into what these can consist of, we merely enumerate possible factors under three subheadings:

1. Primarily going concern factors
2. Primarily resource conversion factors
3. Primarily stock market factors

Any one or combination of these factors could serve as a trigger to buy securities that the investor has already determined are attractive, based on safe and cheap standards.

Primarily going concern factors are those that relate to the operations of a business. They

encompass things ranging from investor beliefs that profitability in the immediate future will increase dramatically, to tenets about dividend increases; from views that current high dividends are safe, to beliefs in the potential of new developments or new research; from optimism about an industry outlook to faith in management abilities.

Primarily resource conversion factors that can serve as a trigger to buy can be more precisely enumerated than can factors that relate primarily to the going concern or to the stock market. Such resource conversion factors encompass possibilities or probabilities of major refinancings, mergers and acquisitions, liquidations, certain common stock repurchases or other large-scale distributions to common stockholders, changes in control, reorganizations, and recapitalizations.

Primarily stock market factors encompass variables ranging from beliefs that a common stock based on existing price-earnings (P/E) ratios is priced below comparable issues, to views that the common stock looks good technically, and to ideas that the company or industry may obtain Wall Street sponsorship. Under primarily stock market factors, we would also include the myriad macro variables that encompass investor perceptions about the economy, about interest-rate levels and about predicted movements in the general stock market or major segments of it.

BENEFITS OF THE SAFE AND CHEAP APPROACH FOR THE OPMI

Investment-Risk-Resistant Commitments

Outside investors using this approach buy and hold securities because issues appear at the time of purchase, and continue to appear while held, to be investment-risk resistant, based on the four essential elements. In contrast to other investment approaches, little or no attention is paid to stock market price fluctuations or to predictions about the immediate outlook for equity prices.

When purchasing equity securities, an OPMI using our approach will not acquire a position for his portfolio unless he believes that the value represented by the particular security is good enough, based on the four essential elements. He does not consciously try to outperform the market over the short run. Thus, investigation in areas other than safe and cheap will tend to be emphasized less than it would be if the investor were striving for more immediate performance.

First, little or no time is spent attempting to gauge the general market outlook, examining technical positions, or making business cycle predictions. Put simply, there is no attempt to hold off buying until the investor believes stock prices are near bottom. Rather, the primary motivation for purchases is that values are good enough. Second, comparative analysis, though always a useful tool, tends to be less important than in other forms of fundamental analysis. The reason, of course, is that the investment goal for OPMIs is to concentrate on acquiring reasonable values rather than on getting the best possible values.

Confidence in Investment Commitments

Such investors tend to have a degree of confidence in their commitments that just cannot exist for those who are significantly affected by day-to-day or even month-to-month stock market fluctuations, or who believe that values are determined by elements based on *soft*, or always shifting, factors, such as earnings estimates, P/E ratios, and technical market conditions. This confidence factor can afford significant rewards in the usual (though far from universal) investment instance where there has been no fundamental deterioration in the position of companies with strong finances whose common stocks are part of the investor's portfolio. The

rewards come because:

- Only an investor confident in the fundamental merits of a security finds it relatively easy to hold or average down at times when prices are depressed because there is a bear market, because earnings have declined or for whatever reason.
- If there is confidence in fundamental merits, it becomes relatively easy to establish positions in common stocks at attractive prices when markets are depressed because of events such as panics or tight money, or because of beliefs that near-term outlooks are poor.
- Only an investor confident in the fundamental merits of a security will hold and/or build concentrated positions in that security.

It is our observation that in bear markets, equity securities that are attractive by our standards may decline in price as much as, if not more than, many general market securities and market indexes. Also, in certain types of frothy markets (such as the new-issue boom which ended in 2000) price performance for securities attractive by safe and cheap standards tends to be much less favorable than is the case for many market indexes. Yet, we have no doubt that over time and over all types of markets, the average diligent unaffiliated investor emphasizing this approach will obtain much more satisfactory results, and a higher total return, than could be obtained using any other method of investment available to him. That is why the approach generates confidence and comfort, and why almost all deal men, creditors, major investment bankers, insiders, and owners of private businesses with whom we have dealt emphasize it in committing their own funds.

Obviously, most passive investments will be better investigated if publicly available documents can be supplemented with other information derived from talking to people known to the investigator (know-who) and from using the investigator's special knowledge about particular companies and industries. Nonetheless, in a wide number of instances the public record alone can be quite sufficient.

Availability of Multiple Exits

One of the huge advantages that safe and cheap has over other investment styles is that, on a long-term basis, the investor can look confidently to a multiplicity of exit strategies. In contrast, in other investment styles the only exit on which to concentrate is the sale in the open market to other passive minority investors. Safe and cheap investors ought to benefit not only from open market price improvements, but if their basic analysis is close to right and open market prices remain depressed, values for stockholders would still get created because companies will continue to grow over time, increasing NAV year over year; will be taken over at prices that represent a premium over market; will refinance and restructure; and companies with strong financial positions will make acquisitions that enhance future earning power.

The safe and cheap approach calls for the holding of securities for a permanent or quasi-permanent basis. Exits from positions are made (a) through resource conversion events (tender offer, merger, liquidation, etc.); (b) when the price of the security trades at a substantial premium over and above NAV; (c) when a permanent impairment of capital occurs (something goes wrong with either the company or the security); and (d) when the analysis supporting the commitment is found to be wrong.

RESTRICTIONS AND DEMANDS OF THE SAFE AND CHEAP APPROACH

Activists and Safe and Cheap

For activists and certain aggressive non-control investors using this approach, finding securities that are attractively priced based on the standards we have discussed is not as difficult as finding doable deals, situations where resource conversions can be made to take place, or where there seem to be probabilities that resource conversions will take place, in the context of cash tenders for control, mergers and acquisitions, going private, and liquidations. Thus, for activists in particular, the emphasis may be on spotting attractively priced doable deals where a resource conversion event may be made to occur. For these people, safe and cheap may be only a secondary consideration; they are more willing to balance the risk-reward equation. In that sense, they differ from us in that they do not necessarily make potential risk a more important measurement than potential reward. Doability, which most often entails obtaining control of a business, may become the most important consideration.

Safe and Cheap and Know-Who

The safe and cheap approach to investing is but one approach. It is not a magic formula suitable for all outside investors or even all activists. There are trade-offs, and the approach has disadvantages, especially for OPMIs. It requires huge amounts of work, especially reading and understanding documents. Know-who—personal relationships with those who are the shakers and movers—is also helpful, and in certain situations essential.

Using know-who does not connote using inside information. Those who use inside information for the purpose of buying and selling securities are violating both specific securities laws and more generalized antifraud provisions of law. Inside information embodies factors that are not generally known but that, if known, would be likely to have a material effect on immediate market prices. This type of information might include forthcoming earnings reports, disclosures of natural resource discoveries, or a pending takeover at a price well above current markets.

The use of know-who in a safe and cheap approach permits an investor who is personally acquainted with insiders to make intelligent judgments about, say, the character and ability of management, corporate long-range plans, or reasons why a business would or would not be vulnerable to competitive inroads.

Missing of Attractive Opportunities

The standards used to minimize investment risk limit the selection of attractive securities. Adherence to the approach results in missing many investment opportunities where securities are attractively priced by standards other than those used by fundamental finance investors. In following the approach, an investor, whether activist or outsider, will forgo many equity investments regardless of price if they do not meet all four essential conditions. For example, an emphasis on financial position could prevent one from investing in airline equities, because of a belief that the industry is dangerously financed (an example of on-balance-sheet liabilities) and would be even if re-equipment programs were modified; in integrated steel and aluminum companies; in many electric utilities, because they may be encumbered with inordinately large capital expenditures requirements (an example of encumbrances that are not disclosed in accounting statements); and in labor-intensive companies with large pension-plan obligations (an example of off-balance-sheet liabilities that are disclosed in financial statement footnotes). This does not mean that at certain prices such securities are not very attractive investments for many. They just do not happen to be attractive for adherents to our approach.

Avoidance of Predatory Control Groups

Under our approach, securities of issuers controlled by those believed to be predators, should be avoided regardless of price by both activists and OPMs. The securities avoided are both equities and debt instruments. Significant clues as to who the predators might be are publicly available from documents filed with the SEC. Some of these clues are discussed in Chapter 20 on company disclosures and information. Especially pertinent in these documents are disclosures about management remuneration, insider borrowings from the company, and transactions between the company and insiders. These disclosures are contained either in the annual-meeting proxy statement or in Part II of the 10-K Annual Report. Disclosures about “litigation” in Part I of the 10-K Annual Report, Part II of the 10-Q Quarterly Report and in footnotes to audited financial statements can also give valuable clues to the caliber of management and control groups. Disclosure of grievances by creditors or securities holders that culminate in lawsuits brought against companies and insiders should serve as warnings that a particular company may not be a satisfactory investment using an investment risk minimization approach.

Restricting the Investment Universe

Those using the approach restrict investments to situations where considerable knowledge about companies can be obtained. This is true for both control and non-control investors. While reliance on public information only is sufficient—or even more than sufficient for certain types of investments, such as investment companies registered under the Investment Act of 1940 and public utilities—in other areas required public information frequently provides insufficient data for making intelligent decisions, as is usually the case when a company is engaged primarily in mineral exploration activities. There is a close correlation between the usefulness of financial accounting and the usefulness of public disclosures as tools for making investment decisions. As accounting becomes more reliable, so do required public disclosures. We also discuss this correlation in Chapter 19 on the uses and limitations of financial accounting.

Most important, since the control and non-control groups value using the same standards, there tend to be clear conflicts of interest between insiders and outsiders. Insiders sometimes will create additional values for themselves by forcing out outsiders via the corporation's proxy machinery that they control, by short-form mergers,² or by the use of coercive tender offers. Force-outs sometimes can be at extremely low prices, because the insiders, by their actions (or lack of actions), have contributed to the depression of stock prices. This conflict of interest presents a realistic threat that limits the appeal of a number of equity securities that would otherwise seem attractive using our approach. It is our observation that attempted force-outs at prices we would consider unconscionably low are relatively infrequent.

Basically, we think most control groups in most situations attempt to treat their stockholders fairly or are forced to do so by circumstances. Nonetheless, outside stockholders are sometimes treated unfairly, and legal recourses available to stockholders are frequently inadequate. First, those who overreach at the expense of stockholders have the independent appraisal weapon in their arsenal. Major or second-tier investment banking houses can be retained either to recommend a force-out price or to approve one chosen by boards of directors. Many independent appraisals seem to be based on a theory that if stockholders are given more than they could realize by sale of the shares on the open market, then the deal is *per se* fair.³ No real reference is ever made to any standards other than stock-price standards.

Stockholder claims of violations of federal securities law may be of only limited help, since in most instances such suits are controlled by attorneys for stockholders who frequently have to be primarily interested in promoting settlements rather than obtaining full dollar value for stockholders. Federal securities laws are basically concerned with disclosures and with fulfilling fiduciary obligations, not fairness. The Supreme Court decision in *Ernst & Ernst v. Hochfelder*,⁴ however, raised some question as to what can be brought to bear by the private bar against professionals such as auditors who fail to fulfill professional obligations insofar as federal antifraud securities laws are concerned. In *Hochfelder*, the Court said that an auditor was not responsible under antifraud statutes for his own “inexcusable negligence” when conducting an audit, but, rather, he may or may not be responsible where there is “reckless disregard for the truth,” and that the auditor is clearly liable under the antifraud statutes only if he is “an intentional participant in

a scheme.”

Resort to appraisal rights under state law where available is of only limited usefulness because in leading states (a) considerable weight in arriving at value is usually given to market prices, and (b) costs of litigation for dissenting stockholders can be enormous.⁵

State law can be helpful in affording some protection to outside stockholders in force-out situations. This has become true especially since the supreme court of the leading corporate state, Delaware, ruled in 1977 that force-out transactions ought to have “business purposes,” and that stockholders are entitled to “entire fairness.” Nonetheless, overall protection for minority stockholders seems to be limited.

Despite the less than strong legal posture of OPMIs, we think that in general the threat of forcing out stockholders by predatory managements and control groups is not a realistic deterrent to an investment program based on the safe and cheap approach.

We think that a crucial reason why our approach has been largely ignored in the accounting and economic literature is that those writing on the subject tend to attribute the perceived information and analytic needs of traders seeking to maximize total return to all investors. Along with others, we believe that it is futile for OPMIs to strive for the maximization of total return. It is our thesis that by not trading and by concentrating on an investment risk-minimizing approach, outside investors can achieve good-enough results, probably beating the market from time to time and on an overall basis, but never consistently.⁶ For the vast majority of noncontrol investors, the best way to wealth is not to try for continuous short-term maximization, but to aim for a performance that is good enough over a long horizon.

In order to use our approach well, both activists and passive investors should have practical perspectives about risk and uncertainty. Investors using the approach need patience and fortitude if their investment operations are to succeed. After all, the underlying thesis for the investor is that, given the elements that determine value for him, he knows much more about the particular security he is interested in than the stock market does.

Understanding Motivating Factors

People and companies rarely act unless they expect a resulting benefit, either for themselves or for others with whom they have identities of interest. In making such decisions, the actors aim to take advantage of certain factors that seem to be present in many resource conversion activities. Understanding these factors is helpful for those using our approach. There are three acronyms that serve as a slang shorthand in describing these factors: TS, OPM, and SOTT. TS stands for *Tax Shelter*, OPM (pronounced “opium”) for *Other People’s Money*, and SOTT for *Something Off The Top*. We discuss these factors at length in Chapter 22 on resource conversion activities.

The normal academic assumption is that, managements work in the best interests of stockholders. We believe that relationships between managements and stockholders, between managements and companies, between companies and stockholders and between stockholder groups are best viewed as combinations of conflicts of interests and communities of interests. We provide a framework for appraising managements in Chapter 11.

Dismissal of the Conventional Wisdom

The normal security-analysis assumption is that certain financial factors, such as large returns on investment, are good *per se*, and such others as intense competition are bad *per se*; we demur. Appropriate judgments about most analytical factors, including high profit margins or rapid expansion, depend upon context.

In minimizing investment risk, it is important to distinguish among variables, depending upon the types of companies being evaluated. Oil companies are not analyzed in the same way electric utilities are, nor are primarily resource conversion businesses analyzed as going concerns are. As we stated elsewhere in this book much of conventional analysis, such as that of Graham and Dodd,

modern capital theory (MCT), and conventional money managers seem to be implicitly based on taking tools especially applicable to a relatively narrow, special case—the equity securities of pure going concerns for example—and then trying to fit those standards to the analysis of almost every type of business and security. Such an approach allows earnings to become a common denominator and point of departure. We, in contrast, consider a strong financial position (safety) to be the more appropriate common denominator and point of departure for most investors.

Financial statements provide the basis for the determination of financial position. In determining financial position, it must be noted that the several financial statements are integrally related to each other: there are necessary relationships between book asset values and accounting earnings as well as between estimated asset values and estimated earning power.

As stated previously, we discount the importance of the concept of primacy of earnings for anyone other than total-return traders and possibly also investors in companies that are special cases, such as public utilities. It is our view that those emphasizing reported earnings are, for a number of reasons, out of step with almost everybody in the United States aiming at wealth creation. First, when primacy of earnings advocates refer to earnings, they tend to mean earnings as reported for accounting purposes, with a view to giving such a number a high degree of precision, precisely reflective of operating results for a past period; investment results, for example, are normally excluded by these people from earnings. Second, these reported earnings tend to be stressed for two purposes: they are thought to be the single best indicator of what future reported earnings are likely to be (here again we do not agree), and earnings as actually reported are deemed to be at any given moment the single most important contributor in determining the market price of a common stock. We also tend to believe that earnings as reported at any time will impact stock prices. We, however, conclude that in general any such impact lacks significant relevance in an investment risk minimizing approach to investments.

Corporate cash and the uses to which it can be put, including distributions to shareholders, are, of course, important to investors. There is an inherent conflict between stockholder needs and benefits from cash distributions, and the needs of companies to retain cash.

There are various methods of distributing cash and property to shareholders, including dividends, share repurchases, liquidation distributions and stock dividends. Stockholders are far from constituting a monolithic group, and among them there are varied and sometimes conflicting interests concerning cash distributions.

In the management of securities portfolios, a positive cash-carry is frequently important—that is, the cash return from holding securities ought to be greater than the cash cost of owning the securities. This sometimes can also be important under our approach because both patience and the use of other people's money are easier to come by if the cash return from investments exceeds the cash cost of owning them.

A basic point about loss companies is that while such companies are sources of tax benefits, for them to have value they have to be *clean shells*—companies in which benefits to be derived from the absence of liabilities for income taxes outweigh the encumbrances to be assumed, either already existing or likely to be created by future activities. This caveat, of course, is part and parcel of our approach, and it gives essentially the same advice to activists buying loss businesses as is given to outside, passive investors buying common stocks.

In conventional analyses today, there is almost no understanding of risk. The prime example of this is the conventional belief that long-term U.S. Treasury Notes, selling near par, are safe and free from risk. Not so. The U.S. Treasury Notes, paying say 2 to 3 percent, do not carry any credit risk; but, they are replete with several other types of risk, such as inflation risk and capital depreciation risk, while at the same time there are no prospects for capital appreciation. The huge amounts of realistic risk inherent in owning U.S. Treasuries today is offset greatly if the portfolio holding these instruments is a dollar-average and will continue to acquire new U.S. Treasuries as interest rates fluctuate. Nonetheless, for most portfolios in 2012, the way to guard against economic risk is to be a total return investor using the safe and cheap criteria rather than to be a cash return investor in U.S. Treasuries.

Short-termism is rampant among market participants. Much of short-termism is appropriate, justifiable, and essential for many market participants. It just happens to be irrelevant largely for safe and cheap investors focused mostly on buy-and-hold, long-term purchases of securities.

One had better be very short-term conscious where the portfolio is highly leveraged; where

the market participant doesn't know much about the company or the securities it issues; where the market participant uses trading systems, or a technical approach to the market; and where the more important variable in an analysis is what is the near-term outlook, rather than what are the underlying values existing in the company and the company's securities.

Even for the largest institutions, it seems to be impossible to have underlying knowledge about an individual security where the portfolio consists of a huge numbers of securities (say over 500 different common stocks) and those securities are traded frequently. This includes high-frequency trading portfolios. If that's where one's interest and attention lies, one should be short term.

Understand Activities and Motivations of Activists

We think that any person involved with fundamental finance can function better if he understands the activities and motivations of activists.

OPMIs following the precepts outlined in this book strive to achieve above-average long-term returns by acquiring the common stocks of strongly capitalized companies at bargain prices. Activists, on the other hand, frequently can achieve super returns in other ways, that is, without necessarily acquiring interests in companies with strong finances or strong operations bought at bargain prices. In Part Five of this book we describe three deals where activists made out extremely well by using finance techniques rather than merely being a buy and hold investor. The three examples are as follows:

1. The 2005 leveraged buyout (LBO) of the common stock of Hertz Global Holdings at a relatively high P/E ratio and a substantial premium above book value. Despite mediocre operating results subsequent to the LBO, the Hertz Global Holdings Transaction seems to have been quite remunerative for the LBO sponsors and their investors. In our view this success is attributable mostly to the fact that time and again the sponsors enabled holders of Hertz Global Holdings common stock to obtain super-attractive access to capital markets. Also sponsors and investors received two large dividends where the funds for paying one of the dividends came from a loan with liberal covenants, and for the other, from the proceeds of an underwritten common stock offering to the public.
2. The 1969 acquisition of Reliance Insurance Company by Leasco Data Processing Company. This is a good example of a small business, almost a start-up, obtaining control of a major property and casualty insurance company without having to invest any material amount of cash unless control was actually obtained. In this case we examine the methods by which Leasco Data Processing Company financed the purchase for cash of the blocks of shares of Reliance Insurance Company, which Leasco believed it needed to acquire if it was to obtain control of Reliance. The case is of interest in part because of the extremely attractive consideration that was given to providers of cash so that they obtained (a) a safe, above-average return on a tax-privileged basis as well as (b) an opportunity to participate in potential market appreciation. This was the epitome of an investment that could be deemed to be attractive using the safe and cheap approach. Yet, the transaction was also highly attractive for others, especially Leasco, because it enabled Leasco to tie up key blocks of common stock without risking cash, unless it was to obtain control of Reliance, and also to use pooling-of-interests accounting

treatment in the future, with consequent beneficial effects on Leasco's reported earnings to its stockholders. (The ability of a company to use pooling-of-interests accounting in connection with an acquisition transaction no longer exists).

3. The 1969 going public offering of the common stock of the parent company of the F & M Schaefer Brewing Company. In this case, the apparent object of the various transactions was to extract as much cash as possible from the business for the control group and still retain control of the business for that group. Although none of the securities issued to noninsiders in that transaction were suitable for safe and cheap investors, the case is still useful. First, it demonstrates that profits can be obtained in many ways by investors, as, for example, the profits garnered by those members of the public fortunate enough to obtain Schaefer Corporation common stock on the initial underwriting who then sold their stock within the ensuing eighteen months. Second, because the transaction was so complex, much is demonstrated about what motivates various purchasers of securities, from life insurance companies to total-return traders, and about various classes of securities that can be issued. Thus, the case is instructive because it demonstrates how insiders used the financial strength inherent in a profitable, almost debt-free business as a basis for extracting maximum cash for themselves, with the result that the successor business became heavily encumbered. The Schaefer case also briefly touches on matters that have to be the concern of any promoter or would-be promoter, including blue sky laws, the National Association of Securities Dealers (NASD) Rules of Fair Practice, Rule 144 and Registration Rights.

Understanding these types of transactions ought to be helpful to OPMIs in gaining insight into how Wall Street operates even though the vast, vast majority of OPMIs will never become activists or promotees of activists.

SUMMARY

Safe and cheap investing is a value investing approach that gives primacy to the avoidance of investment risk. The four main components used in the selection of companies and their equity securities are (1) the company ought to have a strong financial position, something that is measured both by the presence of quality assets and by the absence of significant encumbrances, whether a part of a balance sheet, disclosed in financial statement footnotes, or an element that is not disclosed at all in any part of financial statements; strong financial positions or creditworthiness are a company resource, which provides "insurance" to OPMIs and opportunism to management; (2) the company ought to be run by reasonably honest management and control groups and must operate in markets where regulators provide significant protections for minority investors; (3) there ought to be available to the investor a reasonable amount of relevant information, although in every instance this will be something that is short of "full disclosure"; and (4) the price at which the equity security can be bought ought to be significantly (say 20 percent or more) below the investor's reasonable estimate of net asset value. The benefits and disadvantages of the approach are also discussed.

* This chapter contains original material and parts of the chapter are based on material

contained in Chapter 1 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman); and Chapter 2 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (© 2006 by Martin J. Whitman and Martin Shubik), and ideas contained in the 1999 2Q, 2001 4Q, 2005 3Q, 2008 4Q, 2009 1Q, and 2012 1Q letters to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ We also discuss these factors in Chapter 8 on investment risk.

² In a short-form merger, stockholders can be forced out of a company in a merger or reverse stock split, and have no right to vote on the transaction.

³ See our discussion on fair prices in takeovers in Chapter 14.

⁴ Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

⁵ Unlike class-action suits in federal court, in appraisal procedures in states such as Delaware and New York dissenting stockholders may be liable not only for their own court costs, including attorneys' and experts' fees, but also for similar costs incurred by the company, in the discretion of the court.

⁶ The reader is reminded that the optimization of performance is dependent not only on security or investment selection but also (and most importantly) on the degree of concentration or diversification of the investor's portfolio. See Chapter 13.

CHAPTER 16

Graham and Dodd Placed in Context*

The OPMI Defined

The OPMI Perspective of Analysis

The Going Concern and Investment Company Views of Businesses

Primacy of the Income Account and Wealth Creation

Primacy of the Income Account, Dividends, and Corporate Uses of Cash

Primacy of the Income Account and the Appraisal of Managements

Primacy of the Income Account and Top-Down versus Bottom-Up Analysis

Primacy of the Income Account and Diversification

Primacy of the Income Account and Growth Stocks

Market Risk versus Investment Risk and Margin of Safety

The Importance of Market Performance

Uses and Limitations of Financial Accounting

Substantive Consolidation

Compensation of Promoters

Do Stock Market Prices Reflect Corporate Values?

Trade-Offs

Modern Capital Theory versus Graham and Dodd

Summary

Benjamin Graham and David Dodd (G&D) were prolific writers, publishing volumes in 1934, 1940, 1951, and 1962 and by Ben Graham alone in 1949 and subsequent revised editions.¹ A principal problem with G&D is that almost everyone in finance talks about G&D but very few seem to have actually read G&D. This discussion is based on the 1962 edition of *Security Analysis Principles and Technique* (McGraw-Hill) by Graham, Dodd, and Cottle; and the 1971 edition of *The Intelligent Investor*, by Graham.

Because so many have such a superficial understanding of G&D, their names have become synonymous with the term *value investing*. This, in turn, has led to some confusion about what it is that value investors do. Though we are influenced by G&D, our methods are basically different.

As we have already pointed out, value investing is one area of fundamental finance (FF). It involves investments in marketable securities by non-control outside passive minority investors (OPMIs) using a fundamental finance approach to analysis. The other areas of fundamental finance involve the following:

- Distress investing
- Control investing
- Credit analysis
- First and second stage venture capital investing

Modern capital theory (MCT), like value investing, focuses on investments by OPMIs. Unlike value investors, MCT focuses strictly on near-term changes in market prices. In a number of special cases the factors important in MCT are also important in value investing. MCT is discussed briefly at the end of this chapter and discussed at length in Chapter 17.

G&D made four very important contributions to value investing:

1. Distinguished between market price and intrinsic value (a concept that still seems alien to MCT).
2. Provided a clear and usable definition of investing as opposed to speculation.
3. Pioneered the concept of investing with a margin of safety.
4. Promulgated the belief that investment decisions ought to be based on ascertainable facts. (This was before the modern era—say after 1964—when for OPMIs the amount of factual material exploded and the reliability of factual materials became much enhanced).

Any so-called value investor follows the basic rule promulgated by G&D:

acquire at attractive prices the common stocks issued by primary companies in their industries.

In this chapter we briefly summarize and discuss the differences between our approach to value investing and that of G&D. Many of the differences are foundational in nature, and these foundations have been explained in detail in Part One of this book.

THE OPMI DEFINED

Some participants in investment operations are outside, passive minority investors (OPMIs); others are activists. OPMIs are members of the public and are distinguishable from others in three respects. First, individually they have no control or influence over the businesses whose securities they hold or contemplate holding. Second, they do not have access to information other than that which is generally available to the public. Third, they are those whom the U.S. securities laws and regulations have been designed to protect.²

Throughout the book, we refer to them as OPMIs, as well as non-control and unaffiliated security holders. The key is that they are inactive in management and not connected with the company issuing securities in any way other than as security holders. OPMIs run the gamut from day traders to most institutional investors to safe and cheap investors who do not seek elements of control over the companies in which they hold securities positions. The reason for using the term OPMI rather than *investor* is that the word *investor* is one of the most misused and misunderstood words on Wall Street and is often used to describe what G&D and we would refer to as speculators.

Non-control investors are also supposed to be the beneficiaries of various state laws and regulations, including blue sky statutes governing terms and conditions under which new issues may be offered;³ antitakeover statutes; statutes aimed at controlling going-private transactions; more generalized common law and state statutory requirements covering the fiduciary obligations of those in control of corporations to unaffiliated common stockholders; and statutes defining appraisal remedies when stockholders dissent from force-out mergers or similar force-out transactions. OPMIs are additionally protected by rules promulgated by quasi-public bodies, particularly the Financial Institutions Regulatory Authority (FINRA) and the Public Company Accounting Oversight Board (PCAOB).

We regard as activists those participants in U.S. financial operations who have elements of control or influence over the businesses in which they invest, who have or can obtain nonpublic information and whom federal securities regulation is intended to control rather than to protect. We believe the materials in this book are of interest to both activists and OPMI.

THE OPMI PERSPECTIVE OF ANALYSIS

Both G&D and MCT focus on the investment operation from the point of view of the OPMI. Little, or no, attention is paid to other points of view and the particular factors needed to understand the dynamics driving individual companies, particular industries, control persons, and putative control persons, as well as creditors. This emphasis on the OPMI is in sharp contrast to other areas of FF—control investing, distress investing, and first- and second-stage venture capital investing. Here, the analysis does not focus on OPMI needs and decisions, but is rather a four-legged stool:

1. Understanding the OPMI's needs and desires
2. Understanding the company in some depth
3. Understanding the needs and desires of control persons and entities, present and future
4. Understanding the needs and desires of creditors

As value investors, our analytic techniques, unlike G&D's, are the same as control investors, distress investors, and creditors. The emphasis is on understanding in depth, from the bottom up, the company and the securities it issues; and also the character and motivations of managements, other control entities, and others senior to the common stock, ranging from secured lending by commercial banks to trade creditors to holders of subordinated debentures to holders of preferred stocks. There is a de-emphasis of top-down factors emphasized by G&D and MCT, a primacy of the income account, general stock market levels, near-term stock price movements, a primacy of dividend income, quality or growth as defined by general recognition of such in the general market.

Many of the best value investors graduate into other areas of fundamental finance, especially control investing and distress investing. Names of such "graduates" which come to mind are Warren Buffett, Sam Zell, Carl Icahn, Bill Ackman and David Einhorn.

A subgroup of control investing is what we call "Pain in the Ass" (PITA) investing. PITA investing seems to be carried on very skillfully by Messrs. Icahn, Ackman, and Einhorn. PITA investing involves either buying small- to medium-sized stakes in the equity of underperforming, undervalued companies, or shorting securities that are overpriced and where managements lack integrity or where there might be suspicions of fraud or unsound accounting practices. The PITA investor in these situations has access to large amounts of publicity and using that publicity tries to influence market prices in OPMI markets. PITA investing involves elements of control, but most of the time, the PITA investor does not seek actual control of the business.

Our *modus operandi* is to think like owners, private acquirers, or creditors, emphasizing elements of FF that differentiate us from G&D.

In their analysis of common stocks, G&D emphasize the following factors:

- A primacy of the going concern view of businesses, and the OPMI view of the investor, which leads to:
 - A primacy of the income account—forecast future earnings relying heavily on the past earnings record
 - A primacy of dividend distributions for the OPMI
 - A primacy of appraising managements only as operators
 - A primacy of top-down factors:

- The general level of securities markets
- Outlook for the economy
- Industry identifications
- General market opinion as to the quality and/or growth prospects of an issuer
- A primacy of diversification over concentration
- A primacy of generally recognized growth
- A primacy of market risk over investment risk
- A primacy of market performance rather than business performance
- A primacy of what the accounting numbers are rather than what they mean
- A primacy of the OPMI in the analysis reflected as a primacy of substantive consolidation

As we highlighted, two reasons underlie their focus on these factors of analysis. With minor exceptions, G&D had only one type of investor in mind, the OPMI, and they viewed businesses as pure going concerns.

THE GOING CONCERN AND INVESTMENT COMPANY VIEWS OF BUSINESSES

We differ from G&D and most others writing about fundamental security analysis and corporate finance. Other fundamentalists have a tendency to apply to all companies tools of analysis that in fact are applicable only to that small minority of businesses that are strict going concerns—that is, companies that are engaged in a particular type of operation to be financed, managed, and controlled in the future in about the same way they have been in the past. The analysis of strict going concerns is of limited help when applied to businesses that are also involved in what we call resource conversion activities like mergers, acquisitions, or the purchase, sale, or distribution of assets in bulk; major financial restructurings or recapitalizations; sales of control or contests for control; or the creation of tax shelter. Since most companies, to a greater or lesser extent, are involved in these types of activities, analysis must take into consideration both their static and dynamic investment vehicle attributes.

There are crucial differences between the analysis of companies as going concerns and the analysis of companies as investment vehicles. Most companies have both going concern characteristics and investment company characteristics. In going concern analysis, great weight is given to flows, whether cash or earnings. In investment vehicle analysis, great weight is given to asset values, especially realizable asset values. For both going concerns and investment vehicles, creditworthiness is paramount for the company and its securities holders (except perhaps for adequately secured creditors). G&D emphasize going concerns except for a short description of net nets, which focuses only on classified balance sheets and never mentions creditworthiness or prospects for resource conversion, especially changes of control or going private.

PRIMACY OF THE INCOME ACCOUNT

AND WEALTH CREATION

For G&D values for stockholders are created by earnings that are then valued in the market by a price-earnings ratio (or capitalization rate) and/or dividends, which are valued by the market on a current return basis.

In FF, stockholder values flow out of creating corporate values. There are four different methods of creating corporate values:

- 1. Cash flows available to security holders.** Corporations probably create this fewer times than most people think.
- 2. Earnings, with earnings defined as creating wealth while consuming cash.** This is what most well run corporations do and also what most governments do. Earnings cannot have a lasting value unless the entity remains creditworthy. Also, in most cases, in order to maintain and grow earnings the corporation or government is going to have to have access to capital markets to meet cash shortfalls.
- 3. Resource conversions.** These areas include massive asset redeployments, massive liability redeployments, and changes in control. Resource conversions occur as part of mergers and acquisitions, contests for control, the bulk sale or purchase of assets or businesses, Chapter 11 reorganizations, out-of-court reorganizations, spin-offs, and going privates including leveraged buyouts (LBOs) and management buyouts (MBOs).
- 4. Super-attractive access to capital markets.** On the equity side, this includes initial public offerings (IPOs) during periods such as the dotcom bubble. On the credit side, this includes the availability of long-term, fixed-rate, nonrecourse financing for income-producing commercial real estate.

G&D do not distinguish between cash return investing and total return investing. In cash return investing, returns are measured by current yield (or dividend return), yield to maturity, yield to a worst case, or yield to an event. In total return investing, returns are measured in price paid relative to cash returns plus (or minus) capital appreciation (or depreciation) in given periods of time. Many portfolios have to be invested only for cash return into high-grade credits, such as bank securities portfolios; insurance company portfolios, at least as to the amount of liabilities; certain pension plans. (In the current low-interest environment, it seems almost impossible to be a rational cash-return investor.) For G&D, the higher the dividend, the higher the price at which a common stock would sell. G&D imply that the higher-dividend issue should be acquired. G&D ignore that the lower-priced security may be more attractive to the total return investor because of the lower price and the larger amount of retained earnings.

Two facts stand out in comparing dividend income in the U.S. with interest income:

- 1. Dividends are generally tax-advantaged in the U.S., with individuals currently subject to a maximum federal tax rate of 15 percent on qualified dividends; and corporate taxpayers are generally entitled to a 70 percent exemption from income tax on qualified dividends from domestic companies.**
- 2. In the United States, as a practical matter, no one can take away a creditor's right to a contracted interest payment (or other cash payment) unless that individual so consents or a court of competent jurisdiction, usually a bankruptcy court, suspends that payment.**

PRIMACY OF THE INCOME ACCOUNT, DIVIDENDS, AND CORPORATE USES OF CASH

G&D emphasize the importance of dividends for OPMIs. In contrast, FFs look instead at the corporation optimizing its uses of cash. In general, corporate cash can be dispensed in three areas:

1. Expand assets
2. Reduce liabilities
3. Distribute to equity owners:
 - a. Via dividends
 - b. Via stock buybacks

There are comparative advantages and disadvantages for dividends and buybacks, which are never discussed by G&D, because they only mention the stock buyback alternative as it relates to stock options for management. There is no discussion by G&D of stock buybacks as a method of enhancing a common stock's market price over the long run, giving the management the flexibility to retain cash in troubled times, and also increasing the percentage ownership interest of each nonselling stockholder.

From a corporate point of view, distributing cash to shareholders has to be a residual use of cash, compared to expanding assets or reducing liabilities most of the time. Probably the most important exception to this exists where the payments of common stock dividends in cash give a corporation better long-term access to capital markets than would otherwise exist. This seems to be the case for companies, which by the nature of their operations consume cash in order to create wealth and are required to raise outside equity capital periodically, such as integrated electric utilities and certain financial companies.

PRIMACY OF THE INCOME ACCOUNT AND THE APPRAISAL OF MANAGEMENTS

In a G&D primacy of the income account approach (or any other primacy of the income account approach), managements are appraised almost solely as operators. For FF, managements are appraised using a three-pronged approach:

1. Management as operators
2. Management as investors
3. Management as financiers

In appraising managements as financiers, the emphasis ought to be on a primacy of creditworthiness for either the company or for various securities in the capital structure.

G&D agree that the securities of secondary companies and workout situations can be attractive for Enterprising OPMIs, whom they distinguish from Defensive OPMIs. However, very little is really voiced by G&D as to how secondary situations and workout situations ought to be analyzed, compared with their views on how to analyze the securities of primary companies, other than to state that secondary common stocks should not be acquired except at prices of two-thirds or less of underlying value.

PRIMACY OF THE INCOME ACCOUNT AND TOP-DOWN VERSUS BOTTOM-UP ANALYSIS

G&D is mostly a tool for top-down analysis; while FF, in contrast, is almost completely bottom up. G&D describe how to forecast earnings for a coming 5-to-10-year period:

- Formulate a view as to the general economic climate.
- Anticipate future earnings from the Dow-Jones Index and the S&P 500.
- Forecast earnings for individual companies.

In FF, the essential analysis is of the individual company and the current price of the security versus its estimated intrinsic value. Instead of just forecasting earnings, in FF, prognostications are made about:

- Operations
- Potential resource conversions
- Access to capital markets

PRIMACY OF THE INCOME ACCOUNT AND DIVERSIFICATION

Diversification, quite properly, is key in a G&D analysis. It is an OPMI analysis, which relies heavily on predicting future earnings and future dividends, something extremely hard to do well. In FF there is much less need for diversification which is viewed as only a surrogate, and usually a damn poor surrogate, for knowledge, control, and price consciousness. Non-control value investors need a modicum of diversification, but nowhere near to the degree emphasized by G&D, MCT, and academics in general.

PRIMACY OF THE INCOME ACCOUNT AND GROWTH STOCKS

In writing about growth stocks, G&D seem to define growth as that which is generally recognized in the marketplace as growth. Growth analysis focuses strictly on forecasting future flows, whether such flows are revenues, earnings, or cash. An attractive common stock purchase is deemed to exist where future forecasted growth rates are greater than current ratios of price to flows.

In FF there is no emphasis on estimating future flows. Rather we recognize that growth in common stock prices can come, and frequently does come, from sources other than corporate operations. Growth can come from judicious acquisitions; creating unrealized, and unrecorded, appreciation in asset values, creating “hidden assets” in the form of increases in adjusted book value; having companies taken over by others at premium prices; and possibly participating in corporate restructurings. Many of these growth stocks do not have general recognition, and so they sell at very modest prices. Examples in mid-2012 included Applied Materials, Brookfield Asset Management, Cheung Kong Holdings, Hang Lung Group, and Wheelock & Co.

MARKET RISK VERSUS INVESTMENT RISK AND MARGIN OF SAFETY

G&D believe it is important to guard against market risk, that is, fluctuations in security prices. Thus, it becomes important in their analysis to have views about general stock market levels. FF practitioners guard only against investment risk, that is, the problems of companies and/or the securities they issue. In FF analysis, market risk is mostly ignored except when dealing with *sudden death* securities—derivatives and risk arbitrage securities; when dealing with portfolios financed by heavy borrowing; and when companies have to access capital markets, especially equity markets.

In the analysis of performing credits acquired at or near par, emphasis by G&D is on quantitative data relevant to overall interest coverage, rather than any emphasis on covenants and/or collateral. FF emphasizes covenants and collateral in credit analysis. No matter how favorable the quantitative data, such as coverage and debt ratios, FF practitioners examining most corporate credits assume that the quantitative facts are likely to deteriorate over the long-term life (say a 5-to-15-year life) of a debt instrument. Such an assumption creates a margin of safety for a creditor.

Analysts really ought not to use the word *risk* without putting an adjective in front of it. G&D really do not distinguish often enough between market risk and investment risk, even though they recognize in measuring market risk that Mr. Market tends to be utterly irrational some of the time. *Market risk* refers to short-term fluctuations in securities prices. *Investment risk* refers to something going wrong with the company issuing securities or with the securities (such as dilution).

We largely disagree with G&D as to when low pricing creates a margin of safety. For G&D the margin of safety is created mostly by depressed prices in the general market. For FF, the margin of safety is derived largely from micro factors affecting a company and its securities, not general stock market levels. G&D seem to have a valid point in terms of guarding against market risk. FF is involved with investment risk, not market risk.

THE IMPORTANCE OF MARKET PERFORMANCE

The importance of market price depends primarily on three factors:

1. The form of investments in the portfolio
2. Who the market participant is
3. How the portfolio is financed

Generally, market prices are much less important if a portfolio consists of performing loans. Indeed, in some portfolios, such as high-grade municipal bonds held by individuals, almost no attention is paid to market prices. Market prices are almost always important in evaluating common stocks, except in instances where the common stocks are being accumulated with the idea of obtaining control or elements of control. Market prices are almost always of critical importance where the portfolio is financed by margin borrowings where the collateral for the borrowing are the securities that make up the portfolio.

Sometimes analysis takes funny turns. In a poorly financed company, would one prefer to have had the company issue subordinated debentures or a preferred stock, which is, of course, subordinated to the debentures? If there is a failure to pay interest or principal on a subordinated debenture, the one remedy available to the subordinated creditor is to declare an event of default. Then, either the indenture trustee, or usually 25 percent of the subordinated creditors, can accelerate the debt, declaring it due and payable. For a subordinate class, the right to accelerate most often is the right to commit suicide, because this action would likely result in a

reorganization or liquidation where almost all, or all, the value will go to senior creditors. In contrast to an event of default, the preferred shareholder accumulates dividend arrearages. The company has less need to reorganize or liquidate. If an investor is making a capital infusion into a troubled company, the investor frequently is much better off from a safety point of view by having the issuer issue a preferred stock, rather than a subordinate.

USES AND LIMITATIONS OF FINANCIAL ACCOUNTING

In valuing assets, G&D seem to rely strictly on a classified balance sheet produced in accordance with Generally Accepted Accounting Principles (GAAP). Thus, inventory is viewed as a current asset and real property as a fixed asset. In FF, we focus more on what the numbers mean rather than what they are, and the analysis tends to get different results. In the case of a retail chain, which is a going concern, inventories usually are a fixed asset of the worst sort—subject to markdowns, shrinkage, obsolescence, and misplacement. On the other hand Class A, fully leased income-producing office buildings tend to be current assets, probably an area where price agreement can be reached via one phone call.

For FF, GAAP in the United States is an essential disclosure tool, the best objective benchmark available to the OPMI analyst in the vast majority of cases. However, GAAP and related accounting measures, unadjusted by the analyst, are almost always misleading, in one context or another.

G&D stress the importance of adjusting GAAP to determine *true earnings* for a period. In FF, the analyst always adjusts GAAP, not only to determine earnings from operations, but also to determine creditworthiness and asset values.

GAAP recognizes three classifications on the right-hand side of the balance sheet: liabilities, redeemable preferred stock, and net worth. In economic fact, there are many liabilities that have an equity component. It is up to the analyst to decide what percentages of certain liabilities are close to equivalent to payables and what percentages are close to equivalent to net worth. Take the liability account, deferred income taxes payable, in a going concern. If the cash saved from deferring income taxes is invested in depreciable assets, the tax may never become payable. However, the deferred tax payable account can never be worth as much as tax paid retained earnings (part of net worth) because the tax may someday become payable, especially if the company engages in resource conversion activity, such as being acquired in a change of control transaction. So, maybe there is as much as a 90 percent equity value in the deferred income tax accounts payable. On the other hand, deferred income taxes payable can never be as much of a liability as current accounts payable or interest-bearing debt. Maybe, at the maximum, there is a 5 to 10 percent equity in the deferred tax payable account. GAAP is based on a rigid set of rules; it is no longer principles based. The appraisal of an account, such as deferred income taxes payable, is in the province of the users of financial statements, not the preparers of financial statements.

SUBSTANTIVE CONSOLIDATION

Most OPMIs involved with common stock believe in substantively consolidating the company with its common stock owners. They believe they are buying General Electric (GE), not GE common stock. In FF, the company is a standalone, separate and distinct from its shareholders, its management, its control group, and its creditors. Essential for understanding the dynamics of many companies are not only consolidated financial statements but, also, how financial statements are consolidated. In many cases, it is important to know which liabilities of particular parents or subsidiaries are assumed or guaranteed by other companies, which are part of a consolidation.

COMPENSATION OF PROMOTERS

G&D seem utterly silent about the compensation of professionals and promoters, which has to be understood if one is to understand Wall Street and/or corporate managements. Nothing happens in the financial community that does not entail huge transaction costs for clients, whether those clients are retail, institutional, or corporate. Huge transaction costs for clients mean huge transaction incomes for certain Wall Street participants who incur relatively small costs to create those incomes (i.e., the earning, by these promoters and professionals, of excess returns).

Excess returns are far from the exclusive province of Wall Street. Excess returns also seem to be earned relatively persistently by top corporate executives. These executives include not only principal owners, or sole owners of businesses, but also professional managements that may not be significant corporate stockholders.

Economists have it wrong when they say, "There is no free lunch." What they should say is, "Somebody has to pay for lunch." Those who most commonly pay are OPMIs.

DO STOCK MARKET PRICES REFLECT CORPORATE VALUES?

While ignored by G&D, we are of the strong opinion that common stock prices never have to be rational in the absence of catalysts that are the bedrock of resource conversion. The most important catalyst seems to be changes of control and/or potential changes of control. In a conservative, non-control, FF investment, the common stocks that we have purchased are those of blue-chip companies selling at substantial discounts from readily ascertainable net asset values (NAV). The exit strategies are based on the belief that NAVs will grow over the next three to seven years and that the discounts from NAV will not widen materially. Without catalysts, though, it appears as if the discounts from NAV are just a random walk at any particular time.

Where there are no prospects for changes of control or no Wall Street sponsorship (induced by generous compensation arrangements for managers and securities sales persons), prices in OPMI markets can be utterly irrational persistently. The very best companies whose common stocks are publicly traded and where no catalyst exists usually sell at discounts to NAV. Sometimes these discounts from NAV reach 60 percent or greater.

Many of these companies are extremely well financed and have most impressive long-term records of increasing NAVs and earnings per share persistently. Such companies include Brookfield Asset Management, Capital Southwest, Investor AB, and Cheung Kong Holdings. In contrast, there is a huge market for private equity that OPMIs spend billions of dollars to get into and that are priced at substantial premiums above NAV. These are the hedge funds. Typically their premiums above NAV are reflected in the present value of promotes paid to hedge fund managers. Those promotes normally run to 2 percent of assets under management plus 20 percent of annual profits after the OPMIs receive a preferred return of, say, 6 percent. Further, lengthy lock-up periods tend to exist for OPMIs owning hedge funds, while the publicly traded common stocks cited above are all marketable. From a value point of view, there does not seem to be any rational reason why the publicly traded issues mentioned above should sell at steep discounts, while the hedge funds are priced at premiums.

In FF, potential resource conversions, catalysts, and access to capital markets are included in the valuation process. FF puts a great premium on the value of control, something ignored by G&D. Asset values are very important insofar as they are readily ascertainable and exist in well-financed companies. Asset values are of limited importance in companies that are not well financed and where the principal assets are single purpose, useful only to a going concern. These asset values can have a positive or negative effect on underlying value. They can help predict that future earnings will be high based on an ROE analysis (book value equals E), or they can indicate, and often do, very high overhead and very high fixed costs. A large book value is a negative factor

where the book value consists largely of single-purpose assets, which are costly to keep open, surplus, or obsolete. In the early 2000s this described many U.S. automobile assembly plants and steel mills.

TRADE-OFFS

There are always trade-offs in FF investing. For example, a strong financial position in 2011 means one is dealing with a management willing to sacrifice returns on equity, for the safety and opportunism inherent in a strong financial position. Also, and this is a possibility that G&D do not consider, there are incentives for certain control people to prefer low prices for publicly traded common stocks:

1. Those doing estate planning.
2. Those contemplating taking the company private, including LBOs. Going private entails cashing out public shareholders. To go private two conditions have to be fulfilled:
 - a.Low-to-reasonable price.
 - b.Strong finances—usually by the company itself, or it could be by the buyer or both.
3. Control person is insulated from changes in control.

MODERN CAPITAL THEORY VERSUS GRAHAM AND DODD

MCT, like G&D, is focused on looking at economic and financial phenomena from the point of view of OPMIs. Unlike G&D, the entire focus of MCT is on near-term changes in market prices. MCT operates on the false assumption that markets are efficient for all participants. Unlike one of G&D's great conceptual teachings, MCT does not distinguish between market price and intrinsic value.

When it comes to corporate finance, MCT offers a valuable approach to project finance, but contributes little to corporate finance as visualized by FF participants. The concept of net present value (NPV) is essential for understanding project finance. For a project to make sense, estimates of the present value (PV) of cash flows generated by the project have to exceed the PV of cash costs of the project. In terms of corporate finance, there can be other reasons for undertaking (or not undertaking) a project than positive (or negative) net cash generation.

In terms of capitalization, most MCT believers sign off on the Modigliani-Miller Theorem that if a management is working in the best interest of shareholders, the capitalization is a matter of indifference. The Modigliani-Miller Theorem is an absolute nonstarter in FF. One can't measure creditworthiness without also appraising capitalizations.

In FF, quarterly earnings reports tend to lack significance. However, there are instances where quarterly earnings reports can be important. This tends to be the case for most poorly financed companies, which need virtually continual access to capital markets. FF and MCT tend to coalesce when dealing in sudden-death securities or absolutely creditworthy debt obligations. Such securities seem a special case and encompass the following:

1. Credit instruments without credit risk
2. Derivatives

3. Risk arbitrage, with risk arbitrage defined as situations where there is likely to be a relatively determinant workout in a relatively determinant period of time

In much of what MCT and G&D do, the goal is to estimate the probable effect of certain items on near-term market prices in OPMI markets. Thus, G&D emphasize the importance of determining “true” earnings for a period. In contrast, for FF, the possible or probable effect on OPMI market prices is pretty much ignored in most, but not all, cases. Rather, the goal is to understand the underlying values of a business as well as the business’s dynamics. Such understanding requires a study not only of flows—whether cash or earnings—but also, resource conversion possibilities, access to capital markets, and the quality and motivations of management and control persons.

As we practice it, value investing is a component of FF that stresses intellectual rigor and a long time horizon. The contributions of Graham and Dodd to this approach have been valuable, but they are only part of a much richer story.

SUMMARY

Value investing is one area of fundamental finance (FF). It involves investments in marketable securities by noncontrol outside passive minority investors (OPMIs) using a fundamental finance approach to analysis. The other areas of FF are distress investing, control investing, credit analysis, and first- and second-stage venture capital investing. Graham and Dodd made four very important contributions to value investing: (1) they clearly articulated a usable definition of investing as opposed to speculation; (2) they distinguished between market price and intrinsic value (a concept that still seems alien to MCT); (3) they pioneered the concept of investing with a margin of safety, and (4) they promulgated the belief that investment decisions ought to be based on ascertainable facts. In this chapter we briefly summarize and discuss the substantive differences between the safe and cheap approach to value investing and the approach advocated by Graham and Dodd.

* This chapter contains original material and material contained in the 2011 4Q letter to shareholders.

¹ Benjamin Graham, *The Intelligent Investor: A Guide for the General Reader to Wise Investment Practice Under Today's Financial Conditions*, First Edition (New York: Harper & Brothers, 1949). Later revised editions were renamed as *The Intelligent Investor: A Book of Practical Council*.

² The relevant laws and regulations are the federal securities laws administered by the Securities and Exchange Commission: the Federal Securities Act of 1933 as amended, the Securities Exchange Act of 1934 as amended, the Investment Company Act of 1940 as amended, the Investment Advisers Act of 1940 as amended, the Trust Indenture Act of 1939, and the Securities Investors Protection Act of 1970.

³ The term *blue sky statutes* refers to state statutes governing the terms and conditions on which offerings to sell securities to the public or to buy them from the public can be made in that jurisdiction.

CHAPTER 17

Academic Finance: Modern Capital Theory*

The MCT Point of View

Equilibrium Pricing Is Universally Applicable

The Outside Passive Minority Investor Is the Only Relevant Market

Diversification Is a Necessary Protection against Unsystematic Risk

Systematic Risk Exists

Value Is Determined by Forecasts of Discounted Cash Flows

Companies Are Analyzed Basically as Going Concerns; Investors in

Marketable Securities Are Analyzed as Investment Companies

Investors Are Monolithic: Their Unitary Goal Is Risk-Adjusted Total Return, Earned Consistently

Market Efficiency Means an Absence of Market Participants Who Earn Excess Returns Consistently or Persistently

General Laws Are Important

Risk Is Defined as Market Risk

Macro Considerations Are Important

Creditor Control Is a Nonissue

Transaction Costs Are a Nonissue

Free Markets Are Better than Regulated Markets

The Outside Passive Minority Investor Market Is Better Informed than Any Individual Investor

Markets Are Efficient or at Least Tend Toward an Instantaneous Efficiency

Summary

As we have explained earlier in this book, our approach to value investing entails buying *what is safe and cheap* by an outside passive minority investor (OPMI). The techniques used in value investing are the same or similar to those used in control investing and distress investing. All three involve fundamental finance (FF). Two areas of FF involve passive investing: value investing and credit analysis. The other areas of FF involve active investing and obtaining control or elements of control in distress investing, control investing, and primary and secondary venture capital investing. In contrast to fundamental analysis, academic finance is focused on market prices in organized markets rather than fundamental analysis where the focus is the understanding of a business and the securities issued by that business.

In FF, *what* is refers to the use of analytic techniques that concentrate on the known situation of a company—the quality and quantity of resources in a company, with little or no concentration on forecasts of relatively near term flows (say, over the next 12 months), except for sudden-death events.

Safe refers to the survivability of a business as a business (or securities issued by the business) without any reference whatsoever to price volatility of the securities issued by that business. Safety is measured mostly by strong financial positions; by the quality of resources, if the investor is interested in such junior securities as common stocks; by strong covenant protections; and by reasonable quantitative characteristics in terms of asset coverage or earnings coverage, or both, if the investor is interested in owning corporate debt.

Cheap means an acquisition price for a common stock that appears to represent a substantial discount from what the common stock would be worth were the company a private business or a takeover candidate. In the case of a debt instrument, *cheap* means an estimated yield-to-maturity, or yield-to-workout, that is at least 500 basis points greater than could be obtained from a credit instrument bearing about the same level of ultimate credit risk.

In November 1998, Toyoda Automatic Loom Works, Ltd. (since renamed Toyota Industries) common stock, listed on the Tokyo Stock Exchange, appeared to be a good example of a common stock that was safe and cheap based on *what* is because the company was well financed and represented a way of buying into the common stock of Toyota Motor, a blue-chip automotive manufacturer at a discount of perhaps 35 to 40 percent. Toyota Industries common was trading at about 2,300 yen per share, or about \$16.5 to \$17 U.S. dollars. Its adjusted balance sheet, expressed in U.S. dollars, was as shown in Table 17.1.

Table 17.1 Balance Sheet for Toyota Industries Corporation (Adjusted NAV in \$000s)

	6.0×	8.0×	Per Toyota Industries Share*	
			6.0×	8.0×
Operating income: \$251,570	\$1,509,420	\$2,012,560		
Less: nonconvertible funded debt	\$259,917	\$259,917		
Fixed multiple going concern equity value	\$1,249,503	\$1,752,643	\$3.97	\$5.56
192,725 shares of Toyota Motor common @ \$25/share	\$4,818,125	\$4,818,125	\$15.30	\$15.30
Remaining portfolio of marketable securities at market 11/13/98	\$1,990,129	\$1,990,129	\$6.32	\$6.32
NAV appraising Toyoda as a closed-end Investment Company	\$8,057,757	\$8,560,897	\$25.59	\$27.18
Discount from NAV at market price of \$16.59 for Toyota Industries Common			35%	39%

* Adjusted shares outstanding, 315,000; Toyota Industries Corporation share price @ 11/13/98, \$16.59; exchange rate, 122.65 yen to the dollar.

In 2012, many common stocks of well-financed companies were selling at readily ascertainable discounts. Such common stocks included Capital Southwest, Investor AB, Cheung

Kong Holdings Company, Henderson Land Development, and Wheelock & Company as well as Toyota Industries.

Believers in modern capital theory (MCT) as embodied in the efficient market hypothesis (EMH) and efficient portfolio theory (EPT) never would have valued Toyota Industries operations and the Toyota Industries portfolio of marketable securities in the first place. That is not what they do. EMH and EPT analysis would have been restricted to studying historical market prices for Toyota Industries common and perhaps historical ratios of price to earnings or cash flow. If the discount of market price for Toyota Industries common relative to Toyota Industries net asset value (NAV), which was based largely on the market value of securities held in Toyota Industries' portfolio, were to be explained, the explanation would probably revolve around investor expectations. Furthermore, the discount would probably be viewed as irrelevant, not related at all to either Toyota Industries cash flows or the outlook for the Tokyo Stock Market. These two factors would have been deemed much more likely to influence the near-term price performance of Toyota Industries common than would be the existence of a large discount from workout value.

In November and December 1995, Kmart senior unsecured debentures and trade claims seemed to be good examples of credit instruments that were safe and cheap based on *what is*. On average, these senior issues traded in public and private markets at prices averaging around \$74. These instruments had average yields to maturity of around 18 percent in a market where BB industrial credits were trading at yields to maturity of around 9 percent and BBB obligations were trading at yields to maturity of around 8 percent. BBB is the lowest grade credit that Standard & Poor's, as a rating agency, defines as Investment Grade. Standard & Poor's defines a BBB credit as follows: "An obligation rated BBB exhibits adequate protection parameters. However adverse economic conditions or charging circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation (as compared with credits rated AAA, AA, or A). Obligations rated BB, B, CCC, CC, and C are regarded as having significant speculative characteristics." BB is the highest-grade obligation to be characterized as speculative.

It was problematic at the time as to whether Kmart would have to seek relief under Chapter 11 of the U.S. Bankruptcy Code. If Kmart did seek Chapter 11 relief, all cash service on the Kmart unsecured debt would cease. The odds, however, seemed good that if Kmart ever did enter Chapter 11, the workout values for these Kmart instruments in a reorganization would be at least \$100 or more likely \$100 plus accrued interest. This confidence in the ultimate workout was based, in great part, on the seniority enjoyed by these unsecured debentures and trade claims. There were no secured credits outstanding.

MCT probably would not be involved at all in the specific analysis of Kmart Debt—or other issues of distressed debt—in terms of details about covenants and reorganization processes. The MCT analysis would revolve around studies of the markets for distressed debt and macro statistics about overall rates of money defaults.¹

THE MCT POINT OF VIEW

The previous section is only an example of the vast differences in approach between a value investor and those who subscribe to MCT. In value investing, securities are examined from multiple points of view, including the company itself and control shareholders. By contrast, MCT looks at securities analysis solely from the point of view of outside passive minority investors (OPMIs).

MCT appears to be useful in describing a special case with two components:

1. The sole object of the market participant is to maximize a (market) risk-adjusted total return consistently (i.e., all the time) realizable in cash by sale to the OPMI market.
2. There is a need to examine only a relatively few variables in analyzing a security or commodity. In the securities arena, issues analyzable by

reference to only a few computer-programmable variables seem restricted to the following:

- Credit instruments without credit risk (e.g., U.S. treasuries).
- Derivative securities such as convertibles, options, and warrants. (The values for derivatives are determined by prices of other securities rather than by any analysis of the underlying values attributable to a security, such as a common stock.)
- Risk arbitrage securities where the workouts are short run (i.e., there are relatively determinant workouts within relatively determinant periods of time such as where there is an outstanding tender offer, an outstanding voluntary exchange of securities, or a merger transaction subject to a scheduled stockholder vote).

The basic problem with MCT is that it tries to make a general law out of what is really a very narrow special case. MCT teachings are not very helpful for value investing, where the analysis becomes relatively complicated regardless of whether the object of the analysis involves corporate control factors or buy-and-hold passive investing. Indeed, the underlying assumptions governing the EMH and EPT are either downright wrong or just plain misleading for value investing purposes. Since many (if not all) of these beliefs are so pervasive in the accepted conventional wisdom, we had to discuss many of them in other chapters of this book. However, we thought the reader would benefit from a brief discussion of many of them. Such basic assumptions of MCT focus on the following 20 different beliefs:

1. Substantive consolidation is of prime importance (Chapter 3).
2. Structural subordination is a significant factor (Chapter 3).
3. Equilibrium pricing is universally applicable.
4. The OPMI market is the only relevant market (Chapter 14).
5. Diversification is a necessary protection against unsystematic risk (Chapter 13).
6. Systematic risk exists.
7. Value is determined by forecasts of discounted cash flow (DCF) (Chapters 2, 5, and 6).
8. Companies are analyzed basically as going concerns; investors in marketable securities are analyzed as investment companies (Chapter 2).
9. Investors are monolithic: Their unitary goal is risk-adjusted total return, earned consistently.
10. Market efficiency means an absence of market participants who earn excess returns consistently or persistently (Chapter 14).
11. General laws are important.
12. Risk is defined as market risk (Chapter 8);
13. Macro considerations are more important than bottom-up analysis.
14. Creditor control is a nonissue (Chapter 7).
15. Transaction costs are a nonissue.
16. Free markets are better than regulated markets (Chapter 14).
17. The OPMI market is better informed than any individual investor.

18. Markets are efficient or at least tend toward an instantaneous efficiency (Chapter 14).
19. Focus is on immediate outlooks, that is, short-termism. (Chapter 2).
20. There exists a primacy of the income account as measured by earnings or cash flows (Chapters 2, 11, 19).

EQUILIBRIUM PRICING IS UNIVERSALLY APPLICABLE

William F. Sharpe, a Nobel laureate and a typical efficient-market believer, stated in the third edition of his book *Investments* that if you assume an efficient market, “every security’s price equals its investment value at all times”.² This observation could not possibly be more incorrect or more misleading for value-investing purposes. For value investing, an OPMI market price, especially for a common stock, does not necessarily have any relationship to the price that ought to prevail were the security to be analyzed as issued by a company that is to be involved in mergers and acquisitions (M&As), hostile takeovers, going-private transactions, or liquidations. Not only is there no necessary relationship between prices that prevail in OPMI markets and prices that prevail in other markets (e.g., leveraged buyout [LBO] markets), but there *ought* not to be any relationship because by and large, different factors (e.g., borrowing ability versus near-term reported earnings) are used to determine value in these discrete markets, and insofar as the same factors are used (e.g., availability of control versus dividend policy), they are weighted quite differently.

There are even differences in pricing within value investing itself. Appropriate prices will differ depending on whether the value investor is involved with passive value investing, risk arbitrage, or control investing. Within control investing, pricing parameters tend to vary depending on whether the control buyer is primarily a financial buyer or a strategic buyer. Strategic buyers generally can afford to pay more.

Value investing is an offshoot of control investing. In value investing, a passive investor makes use of the same variables and phenomena in making investment decisions as does the activist, except that the passive investor is not going to have any elements of control that would permit the creation of extra value for the investor in the forms of various edges described in Chapter 22: something off the top (SOTT), such as salaries and perks; an ability to finance personal positions on an attractive basis, as with other people’s money (OPM); and an ability to undertake attractive income tax planning through tax shelters (TSs). The value investor therefore ought to be a lot more price conscious than the control investor, since the latter is often in a position of being able to create excess benefits and excess returns even when overpaying, by many standards, for particular assets. Put otherwise, as far as price is concerned, control investors and OPMIs operate in different markets with different price structures.

To assume equilibrium pricing for all purposes and all markets is to put yourself in a straitjacket precluding your undertaking any analysis of most of what goes on in the financial community—M&As, IPOs, LBOs, and contests for control.

To be involved with value investing, whether as a control person or a value investor, you had best obtain detailed knowledge about bottom-up fundamental factors affecting companies, about securities, about capital markets, and about government regulations and laws. Moreover, in many situations, you should also obtain elements of control over companies; over the processes companies go through, or over both, or else decline to make any investment at all. For example, getting some elements of control over the reorganization process, even if only a negative veto, can be almost essential for success in Chapter 11 investing. This is in contradistinction to MCT, in which the focus is on the behavior of securities prices and markets rather than on obtaining detailed knowledge (and maybe even influence) about the companies in which you might invest.

Risk arbitrage is an investment process involving workouts of securities that are expected to create relatively determinant values in relatively determinant periods of time. One feature that tends to distinguish risk arbitrage from value investing is that although both are passive, investors would be unable to participate in risk arbitrage markets in general unless they are willing to pay up. Risk arbitrage markets tend to have pricing much more attuned to MCT-type efficiencies than do value investing markets. In value investing, a buy-and-hold strategy without determinable workouts, investors desiring to earn excess returns persistently might not be willing to pay more than 50 percent of what they believe the present value of the security would be in a workout or takeover. By contrast, persistent excess returns might be available for risk arbitrageurs whose pricing is equal to 90 to 95 percent of an estimated near-term workout value.

In MCT, there is a belief that markets are efficient or, more accurately, that markets tend toward an instantaneous efficiency. In value investing, there is also the belief that all markets tend toward efficiency. In numerous markets, though, that tendency toward efficiency may take a long time to become effective, and there are frictions that may preclude those efficiencies from ever becoming evident. For example, investors think there are long-term tendencies that ought to result in a material shrinkage in the discount at which Toyota Industries common sells from its NAV, but they do not know about how long it will take for the discount to narrow, the form it will take (could or would Toyota Industries spin off into an investment company its portfolio of marketable securities?), or if it will happen at all. Here, the long-term tendency toward efficiency is quite weak. As a matter of fact, in Toyota Industries-type situations, the security is deemed to be attractive not because of a prediction that the market price will become efficient (i.e., reflect underlying values) but rather because at the price paid, the probabilities that excess returns will be earned over the long term with relatively little investment risk ought to be pretty good.

In simple trading situations (e.g., risk arbitrage), the tendency toward efficiency is very strong and tends very much to be instantaneous. Concerning the statement that *certain* markets tend toward instantaneous efficiency, there is no argument between value investing and MCT, but about the MCT statement that *all or most* markets tend toward instantaneous efficiency, value investors disagree.

In the EMH, the descriptive adjective is *consistently*; in value investing, it is *persistently*. *Persistently* means a majority of the time and on average over a long period; *consistently* means all the time. In value investing, the participant deals in probabilities, never in certainties.

In academic finance, there seems to be just one right price for a security, but in value investing, the right price can cover a wide gamut. A *fair price* in value investing would be defined as *that price, and other terms, that would be arrived at after arm's-length negotiations between a willing buyer and a willing seller, both with knowledge of the relevant facts and neither under any compulsion to act.*³ The one *sine qua non* that causes an OPMI stockholder to become a willing seller is a premium above OPMI market price; the one thing that causes a control buyer to become a willing buyer is a value for the control of the company that is more than the all-in price the control buyer has to pay. Often the spread between a willing seller price and a willing buyer price can be—and ought to be—huge.

Trying to gauge timing, especially about general stock market levels, seems an important consideration in MCT. In value investing, the investor does not gauge timing but rather takes advantage of whatever the market situation happens to be at that time. For MCT, timing is crucial; investors must gauge when prices might change in OPMI markets. One of the great advantages of value investing, especially for control people involved with well-financed companies, is that as activists, they tend to obtain complete control of timing in terms of deciding when to go public or when to go private. For noncontrol investors holding a portfolio of securities selected using value analysis precepts, there seems to be a strong tendency toward being indifferent to timing. If the fundamental analysis is good enough, market performance will be okay, if not for individual issues, then for portfolios consisting of five or more different issues. Put otherwise, if market performance for the portfolio is unsatisfactory, it would not be because of poor market timing but rather because the specific analyses using value investing techniques were flawed.

Special problems exist for the EMH given the concentration on OPMI market price as a universal measure of true value:

- The EMH fails to distinguish between an unrealized market loss and a permanent impairment of capital. In EMH, they are one and the same.

- The EMH fails to distinguish between a paper profit and an inability to cash in on gains for many non-OPMI activists, such as managements of companies that have just gone public via an IPO.
- The EMH fails to understand the huge population of OPMI investors whose needs are met by a contractually assured cash income from interest payments rather than from total return. For example, the vast majority of investors in tax-free bonds have a primary interest in the income generated from holding those bonds rather than in market price. Indeed, most investors in tax-free bonds hold such instruments as lockups and tend to be oblivious to what market prices might be. Tax-frees, also known as munis, are a huge market. These are bonds issued by state and local governments and their agencies. As of March 2012, approximately \$3.7 trillion principal amount of munis were outstanding.⁴
- The EMH adopts unrealistic views in such matters as employee stock options. In value investing, and according to common sense, the value of a stock option benefit to a recipient of those options clearly has no necessary relationship to the cost to the company to issue the options.
- In the EMH, there is a failure to understand that market prices self-correct over time for performing loans with contractual maturity dates.

For value investing, a given price for a security can represent both a tendency toward inefficiency in one market and a simultaneous tendency toward efficiency in another market. For example, examine the price behavior for the 626⁵ publicly traded closed-end investment companies registered under the Investment Company Act of 1940, as amended as of December 31, 1997. These 626 issuers' assets consisted by and large of only marketable securities. Most have all common stock capitalizations, their expense ratios are limited because of regulation, and many, if not most, are managed by mutual fund managers. Prices for mutual fund shares are always at least equal to NAV (as measured by the OPMI market prices of assets) or at premiums of up to 9 percent above NAV because of sales loads. Over 80 percent of the closed-end investment-trust common stocks in contrast trade at a discount from NAV and have traded at discounts consistently. This strongly demonstrates a tendency toward inefficiency in the OPMI market. If the OPMI market were efficient in all contexts, the market prices of the closed-end common stocks would equal precisely the market value of the assets of the closed-end funds, since these assets consist wholly of marketable securities just as is the case for mutual funds. This is the case for no-load mutual funds, not because of any external market efficiencies but because the mutual funds offer and redeem common shares at NAV; there are no other markets for mutual fund shares. At almost no time, however, have any of these closed-end investment-trust common stocks sold at a discount of as much as 35 percent below NAV. This demonstrates a tendency toward efficiency in the hostile takeover market because if shares were available at much greater discounts, hostile takeovers might make sense, even granting that it appears that every closed-end fund currently in existence has adopted significant shark repellents (management entrenchment devices that insulate incumbent control people).

Academic theories that OPMI prices are right, or correct, prices in nonarbitrage markets and therefore good allocators of resources revolve in part around a view that if the OPMI price is wrong, sophisticated investors who know real value will come into the OPMI market and, through their buying, make the price right or correct. Such a view ignores the fact that many, if not most, sophisticated long-term investors and insiders view untrained OPMIs trying to outperform the market consistently as a population to be exploited in going-public or going-private transactions and in providing to insiders SOTT, such as huge executive compensation packages. Such a view also misconceives what sophisticated investors do and do not do. First, they do not necessarily buy in OPMI markets. Many acquire equity positions not by buying common stocks in OPMI markets but rather by receiving, for no monetary consideration, executive stock options exercisable at the OPMI market price existing at the date the options were granted. Insiders generally want OPMI

market prices to be low on the date options are granted, but most would prefer to receive options when a company is private and the exercise price of the option might be book value, rather than after the company goes public in an IPO at a price that might be 5 to 10 times book value. Most sophisticated control investors probably would never be interested in purchasing any common stock in the OPMI market at any price if that common stock did not deliver elements of control over the business. Rather, these people, and institutions, engage in control-type transactions away from the OPMI market, which gets for them promoters' compensations in the context of:

- Mergers and acquisitions
- Hostile takeovers
- Going public
- Going private, LBOs, managed buy outs (MBOs)
- Restructuring troubled companies
- Compensation for passive money management

In contrast to the conventional other financial disciplines, an underlying tenet of value investing is that for most purposes most of the time, many common stock prices in OPMI markets are either going to be far above liberal estimates of what corporate values would be if no OPMI market existed and that many other common stock prices in OPMI markets are going to be far below conservative estimates of the corporate values that would exist for private businesses and takeover candidates. In an active world, control people and quasi-control people arbitrage these differences between OPMI pricing and corporate values. When very high OPMI market prices can be realized, new issues are sold to OPMIs as IPOs and, say, real estate tax shelters. The dotcom bubble, before it burst in early 2000, was an example of crazy high prices for IPOs. In 1996, it seemed as if medical device companies that had received preliminary Food and Drug Administration (FDA) approval might receive a pre-public offering value, based on the price at which the issuer was to go public, for their equity of as much as \$100 million, even though the businesses had virtually no revenues and were reporting losses. When very low OPMI prices exist (probably in combination with corporations' being reasonably well financed), existing common stock issues are acquired from OPMIs in going-private, M&A, and hostile takeover transactions (e.g., the 1990 LBO of Big V Supermarkets).

For the vast majority of firms (electric utilities used to be a notable exception), the variables used to value a business are different from those used to evaluate a common stock trading in an OPMI market. When the same variables are examined—say, the near-term earnings outlook—their importance is weighted quite differently, so there is no basis for concluding that OPMI market price is the best or even a reasonable measure of corporate value.

THE OUTSIDE PASSIVE MINORITY INVESTOR IS THE ONLY RELEVANT MARKET

For MCT, there seems to be but one relevant market: the OPMI market. In value investing, there are myriad relevant markets, including the following:

- Outside passive minority investor traders' market
- Outside passive minority investor investment markets
- Markets for control of companies
- Leveraged buyout markets
- Consensual plan markets in Chapter 11 reorganizations
- Credit markets

- Initial public offering markets
- Markets for settlement of litigation

Efficient pricing in one market—the OPMI market, for example—is *per se* inefficient pricing in another market—the takeover market in value investing, for example. Almost any control buyer seeking to obtain control of a company whose common stock is traded in an OPMI market will have to offer a premium over the OPMI market prices if he or she is to attempt to acquire control using a cash tender offer or exchange of securities. A premium, too, probably (but not necessarily) has to be paid by a control buyer acquiring large blocks of common stock for cash in the open market or private transactions, or by a buyer using corporate proxy machinery and acquiring control through a voting, rather than direct purchasing, mechanism.

The importance of market price varies with the situation in value investing. Although market price may be all-important to the OPMI holder of common stock, it tends to be far less important to the holder of control common stock or to the unlevered holder of a performing loan.

DIVERSIFICATION IS A NECESSARY PROTECTION AGAINST UNSYSTEMATIC RISK

Diversification as a hedge against unsystematic risk is a central tenet of EPT. It is part and parcel of the capital asset pricing model (CAPM). For value investing, diversification is only a surrogate—usually a poor one—for detailed knowledge about the corporation and its securities, control, and price consciousness and also, in some cases, ability to obtain attractive financing for a transaction.

Whether a value investor ought to concentrate or diversify depends on how much knowledge, control, outside (preferably nonrecourse) finance, and bargain pricing the investor can obtain. Certainly, followers of the EMH ought to diversify. The EMH is addressed to those who study securities market prices and have no detailed knowledge about corporations, to noncontrol OPMIs, and to people who utterly lack price consciousness because they assume that the OPMI market price is an equilibrium price with universal applicability. That diversification seems particularly appropriate for MCT passivists, however, does not mean that diversification is also completely inappropriate for others. Following is an investor matrix describing, in general terms, groups and individuals that should concentrate (top) to those (bottom) that should diversify:

- Business school graduate using all his or her resources—personal and financial—to start up a new business he or she will head
- A company, now in one line of business, that is undergoing an M&A
- Leveraged buyout fund
- Venture capital fund
- Investors in high-grade performing loans seeking reasonable amounts of cash income
- Knowledgeable value investors
- Knowledgeable risk arbitrageurs
- Typical OPMIs
- Investors using the teachings of MCT

SYSTEMATIC RISK EXISTS

Part of EPT is the belief that systematic risk—common factors that will affect all companies whose common stocks are publicly traded—exists. Such factors include the business cycle, changes in market indexes, interest rates, and inflation. Systematic risk also is a nonstarter for value investing. Each of the above factors has different effects on different companies and the securities issued by those companies. A severe industry-wide depression helped rather than hurt Nabors Industries in the late 1980s. Nabors, which enjoyed strong finances, was able to acquire a huge fleet of oil and gas drilling rigs on a bargain-basement basis, in great part because virtually all its competitors had questionable financial strength. Reduced market prices in the 1970s, caused by weak general markets, permitted Crown Cork and Seal to repurchase its own common stock at much more attractive prices than would have otherwise been possible.

General inflation and the increased costs associated with it probably would prevent a lot of new competitors and even existing competitors from spending the huge amounts of money it would take to become a new entrant or an expanded entity in diesel engine manufacture in order to compete with Cummins Engine. It is simply a gross oversimplification to assert that there exist common factors that would affect all American businesses. This is the tenet underlying systematic risk.

Systematic risk may in fact exist in a nonfinancial context. All corporations and all investors might fare poorly if the areas in which they are located are rife with political instability and physical violence. These have been unrealistic scenarios for industrialized countries, especially the United States, which, it is hoped, will continue to be the case.

VALUE IS DETERMINED BY FORECASTS OF DISCOUNTED CASH FLOWS

For MCT, the worth of a common stock is the present value of future dividends. For value investing, by contrast, the worth of a common stock is the present value of a future cash bailout, whatever the source of the bailouts. Cash bailouts can come from the benefits of control, sale to an OPMI market, distributions to shareholders, or various conversion events, including sale of control of the business or refinancing on attractive terms.

Brealey and Myers stated in *Principles of Corporate Finance*, that “only cash flow is relevant” (p. 96).⁶ They are wrong, certainly for value investing purposes. Copeland, Koller, and Murrin stated in *Valuation—Measuring and Managing the Value of Companies*, “the manager who is interested in maximizing share value should use discounted cash flow (DCF) analysis, not earnings per share, to make decisions” (p. 72).⁷

The vast majority of projects that make sense create positive cash flows for a corporate owner over the life of the projects viewed as standalones. Very few corporations operating as going concerns, however, ever create cash flows consistently. Indeed, most are relatively consistent cash consumers that have to finance the cash deficits they create by obtaining outside capital, usually borrowings, on a regular basis. In value investing, there are four approaches to wealth creation, which are discussed in more detail in Chapters 5 and 6.

In any event, value investing is founded on a balanced approach. Here there is no primacy of forecasted future flows, whether cash or earnings. Rather, the interrelated elements needed to ascertain value are quality of resources in the business, quantity of resources, and long-term wealth creation power. There are four general interrelated ways to create corporate wealth using a value investing approach:

- Cash flows available to security holders. Corporations probably create this fewer times than most people think.
- Earnings, with *earnings* defined as creating wealth while consuming cash.

This is what most well run corporations do and also what most governments do. Earnings cannot have a lasting value unless the entity remains creditworthy. Also, in most cases, in order to maintain and grow earnings the corporation or government is going to have to have access to capital markets to meet cash shortfalls.

- Resource conversions. These areas include massive asset redeployments, massive liability redeployments and changes in control. Resource conversions occur as part of mergers and acquisitions, contests for control, the bulk sale or purchase of assets or businesses, Chapter 11 reorganizations, out-of-court reorganizations, spinoffs, and going privates including LBOs and MBOs.
- Super-attractive access to capital markets. On the equity side, this includes initial public offerings (IPOs) during periods such as the dotcom bubble. On the credit side, this includes the availability of long-term, fixed-rate, non-recourse financing for income producing commercial real estate.

COMPANIES ARE ANALYZED BASICALLY AS GOING CONCERNS; INVESTORS IN MARKETABLE SECURITIES ARE ANALYZED AS INVESTMENT COMPANIES

For modern capital theorists, businesses are to be analyzed as strict going concerns, engaged in continuing operations, managed pretty much as they always have been managed, financed pretty much the way they always have been financed. Valuations are based on determining the present value of estimated future flows, whether cash or earnings.

For value investing, though, businesses are to be analyzed both as going concerns and resource conversion vehicles engaged in deploying assets, in redeploying assets, and in refinancing activities, including M&As. Valuations are based not only on determining cash or earnings flows but also on examining the company's separable and salable assets and gauging the company's prospects for accessing capital markets at ultra-attractive pricing.

Corporate analysis is complicated by the assumptions that no universal price equilibrium exists; that most businesses are appropriately analyzed as both going concerns engaged in day-to-day operations and resource conversion companies employing and redeploying assets and financing and refinancing liabilities; and that most businesses are likely, over time, to engage (or be engaged) in such conversion activities as M&As, hostile takeovers, and goings-private.

Once a corporation is viewed as a resource conversion complex rather than a strict going concern, then estimating future flows, whether cash or earnings, tends not to remain the sole, or principal, factor in a valuation. Rather, measuring the quality and quantity of resources existing at a particular moment becomes important.

Once it is assumed that no universal price equilibrium exists, the form of consideration paid may become much more important than the nominal value of a transaction, as measured by OPMI market prices. Which would be more valuable to a control seller, \$100 million cash or \$180 million market value of restricted common stock of the acquiring corporation? Besides price, in

any merger or LBO transaction, the following factors will almost always be important considerations:

- Tax impact on important parties to the transaction
- Acquirer's ability to finance the transaction
- Accounting treatment, especially if the surviving company is to remain public
- Representations and warranties of each side
- Other contract terms (e.g., bust-up fees)
- Control issues as they affect corporate executives
- Probability and timing of closing the transaction
- Transaction costs
- Feasibility of the surviving corporation
- Financial incentives to insiders
- Probable impacts on OPMI market prices
- Probable reactions of the risk arbitrage community
- Minority shareholder litigation
- Government approvals

In MCT, there seem to be two principal exceptions to viewing the firm as a strict going concern. The first exception is when the value of a corporation's assets (and sometimes liabilities) can be measured by reference to OPMI market prices. Thus, in the EMH, a portfolio of performing loans will be valued at market insofar as it is deemed to be "available for sale." In this case, the future interest income potential of the portfolio is ignored. Even though assets that trade in OPMI markets are almost always marked to market under the EMH, there are exceptions when OPMI market prices are not in sync, as is the case for closed-end investment companies, which almost always trade at discounts from the OPMI market values of their portfolios.

The second exception concerns M&A accounting. Purchase accounting is a resource conversion concept that blends into the financial picture not only results from operations but also results of the price paid to acquire another going concern. If that price is ultrahigh compared with the acquired company's NAV, future income accounts may be burdened by a noncash charge for goodwill impairment, which would reflect management's mistakes in their role as investors as opposed to operators.

In MCT, there does not appear to be any recognition that analysis based on a going concern approach results in different, and often opposite, conclusions from those that arise out of a resource conversion approach. In value investing, this dichotomy is recognized. Both going concern analysis and resource conversion analysis are valid. Which should be weighed more highly depends on the security being analyzed and the position of the investor undertaking the analysis.

Although noninvestment companies are evaluated, under academic finance, mostly as going concerns striving only to create cash flows from operations, investors in the securities of those concerns are evaluated on the basis of total-return concepts—flows plus valuation of portfolio holdings at market. Under MCT, however, investors are treated as the equivalent of investment companies even though many investors may have as their principal objective the creation of income from interest and dividend payments, which, of course, for analytic purposes, makes them the equivalent of going concerns.

INVESTORS ARE MONOLITHIC: THEIR UNITARY GOAL IS RISK-ADJUSTED

TOTAL RETURN, EARNED CONSISTENTLY

Investors are anything but monolithic in value investing. Most will have multiple—or at least a mixture of—investment objectives:

- Cash return versus total return
- Long-term OPMI versus trading OPMI
- Control versus OPMI
- Control total return, usually including benefits in the forms of SOTT and access to attractive financing

Successful value investors as part of their analysis, understand other relevant points of view: those of long-term buy-and-hold OPMIs, trading OPMIs, the corporation itself, managements, control shareholders, governments, vendors, lenders, employees, investment bankers, accountants, and local communities. They know it is important to figure out who has the clout and what has to be done to satisfy the clout as part of the process of earning excess returns.

Investors and investment advisers concentrating on asset allocation and diversification seem *per se* to be speculators who start out with the following assumptions:

- Outside passive minority investor price is an equilibrium price.
- Outside passive minority investor prices will change as conditions change; therefore, focus on buying what is popular, when it is popular, or likely to get popular.
- Do not obtain much knowledge of the specific company or the securities it issues.
- Be nervous.

Asset allocators who believe in academic finance allocate investments in equity portfolios by concentrating on outlooks for particular industries and on outlooks for specific geographic locations; the better the near-term outlook, the more funds are allocated in that direction. In value investing on the other hand, asset allocation is price driven rather than near-term-outlook-driven; the cheaper an equity appears to be, on the basis of the three-pronged balanced approach, the greater the proportion of funds invested there.

MARKET EFFICIENCY MEANS AN ABSENCE OF MARKET PARTICIPANTS WHO EARN EXCESS RETURNS CONSISTENTLY OR PERSISTENTLY

MCT's underlying assumption that market efficiency means no consistent or persistent returns for any one participant has no basis in reality, except for OPMIs who analyze and invest using MCT precepts. Indeed, control investing is about getting something out of being involved with securities over and above the rights and privileges that flow from being the passive owner of a common stock, a fee interest in real estate, a preferred stock, a loan, a trade receivable, or a leasehold interest. How that something extra is obtained in corporate America and in the financial community is a subject worthy of systematic study and is examined in Chapter 14's discussion of

promoters' and professionals' compensations.

The only rational definition of efficiency for markets in which little or no discipline is imposed by external forces is that excess returns have to be earned persistently and even consistently in that market and that abuses will surface.

It can be theorized that no excess returns are ever earned in any market in which an asset value is marked to market. Earnings here determine the market value, so anytime earnings increase, market value increases correspondingly. Thus, no excess returns are earned, at least as a percentage of the market value of the earnings attributable to those assets. This may not be a useful concept, however, when assets that give rise to the excess returns are not marketable (e.g., top management salaries arising out of management control of proxy machinery, plus charter and bylaws full of shark repellents entrenching management in office). For value investing, it is equally relevant to measure excess returns both by examining returns as a percentage of cost or by depreciated cost, and also by examining returns as a percentage of market value. Weighting assigned to cost or market is dictated by specific circumstances.

For MCT, efficiency means that all information affects an OPMI market price, so that no participant in an OPMI market earns excess returns consistently. For value investing, efficiency means that there are not only OPMI trading markets in which MCT-type efficiency exists but also myriad markets in which little or no external disciplines are imposed, so that participants in those markets earn excess returns persistently. Indeed, in these markets with little or no imposed external disciplines, if excess returns were not earned persistently, those markets, under value investing would be inefficient.

Activists seeking to earn excess returns persistently ought to seek out those fields in which external disciplines are weak or absent. The following forces are supposed to impose disciplines that in turn impose curbs on market participants' earning excess returns:

- Competitive markets
- Boards of directors
- Customers
- Vendors
- Labor unions
- Communities
- Social and religious consciousness

The following markets seem to be the least disciplined areas in the United States today:

- Top management compensations
- Plaintiffs' attorneys
- Investment bankers
- Bankruptcy professionals
- Leveraged buyout packagers and promoters
- Mutual fund management companies
- Hedge fund operators

There are problems with U.S. financial markets, albeit they appear to be far and away the best that have ever existed. Here are a few of the problem areas:

- Promoters' compensation seems far too high under the U.S. financial system.
- Debtors, especially debtor managements, get too much entrenchment, protection, and compensation when restructuring public companies either out of court or in a Chapter 11 case.
- Initial public offerings tend to be grossly overpriced for their actual business value.
- Overwhelming institutional pressures exist to give resources to issuers able to deliver large gross spreads to the financial community, the merits

- of a particular issue notwithstanding.
- Regulation of trading markets is onerous.
 - Investment company regulation is particularly onerous.
 - The tax code is a nightmare, albeit administratively highly efficient compared with other economies. The code's sheer complexity is a burdensome problem, but the Internal Revenue Service (IRS) code must be complex to produce one final result: what the tax bill will be. Other measurement systems, especially Generally Accepted Accounting Principles (GAAP), do not have to be complex. GAAP do not give final results; rather, they are only objective benchmarks that analysts use as one tool to determine approximate values and aid in examining alternative courses of action. From a taxpayer's point of view, a taxable event has three elements: (1) What is the tax rate? (2) Does the taxpayer control timing as to when the tax might become payable? (3) Does the event that gives rise to the tax also create the cash with which to pay the tax?

GENERAL LAWS ARE IMPORTANT

MCT and indeed economics in general place primary emphasis on promulgating general laws. Although other, more mature social sciences, such as law and psychology, admit to the importance of general laws, they focus instead on individual differences that exist on a case-by-case basis. Value investing does promulgate general laws, but they have important exceptions. A first example is this: As a general law in value investing, quarterly earnings reports are unimportant; however, reported earnings for a quarter may be paramount to companies seeking to issue common stock in a public offering or in a merger transaction. A second example concerns price: In value investing, the general law is to try to buy bargains; that is, do not pay more than 50 to 60 percent of what you believe the security would be worth were the business a private entity or a takeover candidate. The exception is that you ought to be prepared to pay up (i.e., have a different pricing standard) if you are involved with risk arbitrage. Here, the 50 to 60 percent guideline might become 90 to 95 percent.

To the user, the ultimate value of a value investing approach compared with the value of academic finance depends on how realistic and useful the various assumptions are. Depending on context—say, day trading compared with a passive buy-and-hold strategy—each approach has validity. For day trading, a MCT approach seems a lot more useful than a value investing approach; for a passive buy-and-hold strategy, value investing seems more useful than MCT. Obviously, this book is based on the belief that for most participants in most investment processes most of the time, value investing is more valid and useful than is academic finance. Furthermore, it strongly supports the belief that value investing ought to be the context of choice from a public policy point of view when promulgating securities law and regulation, when deciding lawsuits involving valuation and disclosure issues, and when promulgating accounting principles in accordance with GAAP or IFRS.

In any specific value investing analysis, the individual differences become much more important than the general laws. Thus, this book refers to “most of the time,” not “all of the time.” For example, in the management of corporate affairs, it is most productive most of the time to take actions based on management's beliefs about the long-term consequences of those actions; in most cases, this would entail ignoring near-term considerations insofar as those factors detract from creating cash flows or long-term corporate values. If the corporation needs to finance by seeking outside equity capital, however near-term considerations might have to dominate. Specifically, most of the time, corporate managers ought to manage so as to increase cash flows and basic corporate wealth even if this means sacrificing current earnings per share as well as reported

earnings per share for the quarterly periods immediately ahead. If the corporation or its insiders need to raise equity capital in the short term though—say, over the next 12 months—it might be better to manage to increase earnings per share and to do things Wall Street analysts like, such as having the company operate as a pure play in an industry rather than be diversified. The risk of not being short-run conscious here seems to be not so much the prices at which issues of equity securities might be marketed by corporations or insiders but whether such issues can be sold at all.

In addition, in value investing, what you think of underlying factors tends to be more important than what you think other people think most of the time. What other people think—the conventional OPMI market wisdom—does tend, however, to become of critical importance to such activists as issuers and promoters when they seek access to outside capital markets, especially equity markets. Seeking such access tends to be an irregular, occasional event for most companies, rather than a continuous process, except for certain types of issuers—which now seem to be a minority of issuers—such as electric utilities, growing finance companies, and many real estate investment trusts (REITs).

Trade-offs are tricky in the value investing scheme of things. In a simple world, it might be said that super-pricing for IPOs results in a misallocation of resources because it results in overinvestment in growth companies in hot industries and underinvestment in other parts of the economy. Perhaps this is so, but it seems obvious that the super-pricing available for IPOs has in effect created a rather dynamic venture capital industry in the United States. During the 1990s, such investments, possibly in combination with an increased supply of technically competent people freed up because of defense cutbacks, seem to have made this country the premier economy for innovation and start-ups associated with such high-tech areas as digital communications and biotechnology. Certainly, the IPO phenomenon has made many of these high-tech companies real businesses because as a result of the going-public process, they have become extremely well financed. Also, the popularity of IPOs has resulted in dedicated managements. Most IPOs raise money only for the company. For insiders to realize a cash bailout after an IPO, the business generally has to prosper. Initially, all an IPO at \$10 per share does for insiders who acquired common stock at 2 cents a share is give them cocktail party points in discussing their net worth. To convert that paper net worth to a meaningful realization probably requires in most cases that the underlying business actually prosper.

For most existing public companies, the sale of new issues of common stock has tended to be a marginal undertaking in terms of amounts of funds raised as compared with seeking other sources of outside capital in various credit markets, ranging from bank loans to other institutional borrowings to public debt offerings. Selling new issues of common stock is quite important, however, in that equity funds provide a borrowing base permitting more senior borrowings on more favorable terms for an issuer than would otherwise be the case. Probably most important, most activist managers properly believe that OPMI markets are capricious in terms of (1) pricing at any given time versus business value and (2) the availability of OPMI markets as a source of new equity capital on a reliable basis. Raising equity money by accessing capital markets tends to be quite expensive, ranging from, say 2 to 8 percent of the funds raised. Most of the new equity capital for businesses is therefore derived from retained earnings rather than the sale of newly issued common stock. In doing so, most active managers properly focus first on the needs of the business, both aggressive and defensive, and only second on the needs or desires of OPMIs. There is no substantive consolidation.

RISK IS DEFINED AS MARKET RISK

For MCT, *risk* means market risk—what will happen to the price of a security—but for value investing, *risk* means investment risk most of the time—what will happen within the business and to the terms of the securities it has issued without regard to the market price of those securities. Value investors basically calculate risk by measuring what can go wrong with the business against the price paid for a buy-and-hold security. For passive investors acquiring securities using a fundamental finance approach, there are four steps in the analysis of a security, shown below in descending order of importance:

1. Compare price with private business or takeover value.
2. Consider what can reasonably be expected to go wrong with the business from an investment—as distinct from a market—point of view.
3. Speculate on what reasonable exit strategies might exist three, five, or seven years in the future.
4. Factor in general stock market considerations.

For most analysts most of the time, steps 1, 2, and 3 will be so important that step 4 can be ignored completely.

MACRO CONSIDERATIONS ARE IMPORTANT

Given the political stability that prevails in the United States and most of the industrial world, it is rare indeed in value investing that macro considerations become important in analyzing and investing in the deal. Macro considerations were probably important in 1929, 1933, 1937, 1974, and 2008–2009. Draconian macro events seem infrequent enough that the value investor can safely ignore them. Another reason to ignore them is that no one seems to be able to forecast them.

In academic finance, it is believed that such macro factors as the level of interest rates, the level of various stock indices, gross domestic product (GDP), employment data, and inflation, indices are virtually always extremely important inputs into most valuation processes. For value investing, individual business performance has always been more important in determining securities price performance on either a buy-and-hold or a control basis than have been macro factors, except in maybe the aforementioned specific years.

In considering general conditions in value investing, it is apparent that since World War II, industry-wide depressions have occurred with amazing persistency. The difference between now and the 1930s, though, is that now there is little or no domino effect from these depressions. Between 1973 and 1998, almost every U.S. industry went through depressions as severe as anything experienced by the particular industry during the 1930s, even though the U.S. economy was generally prosperous. These severe depressions affected, among others, the automobile industry, aluminum, steel, machine tools, energy, banking, real estate, savings and loans, row crops, airlines, water transportation, retail trade, and nuclear-dependent electric utilities. Typically, many of the publicly traded common stocks of companies in depressed industries become ultracheap, as measured by both the quality and quantity of business resources, even as they appear quite expensive measured by price to current earnings and price to earnings forecast for the period just ahead.

CREDITOR CONTROL IS A NONISSUE

In MCT, the appropriate capitalization seems to be driven by OPMI needs and desires, whereas in value investing, it is driven by needs of the company, bailout of the clout, or both. Capitalization is discussed more fully in Chapter 7 on creditworthiness.

Most corporations borrow money. They will be governed very much in what they do about shareholder distributions because of what their contractual agreements are with lenders as well as their probable sensitivity to lenders' needs and desires. Such lenders are both financial institutions and providers of trade credit. Also increasingly affecting shareholder distributions in recent years

has been the emergence of mutual funds and individuals holding high-yield junior corporate debt and preferred stock.

TRANSACTION COSTS ARE A NONISSUE

In academic finance, transaction costs seem to be all but ignored except for bankruptcy costs. For value investing, there are virtually no financial transactions in any arena with which Wall Street is involved—except maybe discount brokerage (and that is doubtful)—that do not involve huge transaction costs. For certain participants in financial processes, huge transaction costs mean huge transaction incomes, even after overhead.

FREE MARKETS ARE BETTER THAN REGULATED MARKETS

Lots of people—maybe most—would deny that resource allocation is the primary justification for the existence of the investment processes. Most would probably say that the primary purpose for the existence of the financial community is to provide investor protection, especially for holders of OPMI common stock. They seem to reason that if such investor protection were provided, it would, *a priori*, result in efficient resource allocation. This book does not agree with this view. It cannot be assumed that efficient asset allocation will result if investment decisions are made by the investing equivalent of kelp and plankton of the marine food chain—uneducated passive reactors whose goal in investing is to outperform a market consistently.

The most important things to realize about any financial system in any economy is that it is going to be replete with elements of inefficiency, misallocation of resources, frictions, and basic unfairness and that there will always be trade-offs. For example, it is a *summum bonum* for an economy to operate in an environment with high levels of integrity for securities trading markets, but overwhelming evidence indicates such integrity cannot be attained without onerous regulation, which obviously has counterproductive elements. The high degree of regulation of trading on the floor of the NYSE is but one example of this. As far as can be seen, the U.S. financial system's allocation of resources is good enough, even if it is acknowledged that from a long-term company-oriented point of view, OPMI markets grossly misprice a very large number—probably a majority—of common stocks.

Nonetheless, a historical focus on investor protection has had tremendous secondary benefits for all U.S. capital markets:

- The integrity of U.S. trading markets is superb.
- The U.S. public disclosure system is superb.
- Oversight of fiduciaries and quasi-fiduciaries is pretty good.
- Senior credit markets, both public and private, tend to be pretty efficient, partly because corporate disclosures, especially audits, have become so good.

Conversely, the focus on investor protection (i.e., OPMI protection) has also had unfortunate consequences in the United States:

- Generally accepted accounting principles have been bastardized. They

are used to seek truth in reported earnings rather than to provide knowledgeable investors with objective benchmarks to be used as essential tools of analysis.

- Crazy legal theories, have proliferated, exemplified by fraud-on-the-market lawsuits, which postulate that plunges in OPMI market prices are evidence of insider fraud because the common stock never would have achieved high prices in efficient markets in the first place if insiders had made full disclosures.
- Stockholder litigation, driven by attorneys' fees rather than merits, has become commonplace.
- Many corporate managements and activists have become far more oriented toward short-run results than is really productive for the economy.
- For issuers that need access to capital markets, there tends to be a primacy of reported earnings; that is, what the numbers are becomes more important than what the numbers *mean*, especially short term.

Efficient-market theories, based on a view that the constituency to be served is the short-run-conscious, unsophisticated OPMI, have caused numerous problems. They were the proximate cause of the derivatives debacle of 1987 because of the failure to distinguish between credit risk and other risks. Also, they fostered an environment in which OPMI do not believe they have to know anything.

There are three principal roles of the Securities and Exchange Commission (SEC) and these involve some conflicts with free markets. If the Securities and Exchange Commission did not foster regulation in these areas, the climate for OPMI investment might be as poor as it seems to be in most emerging markets. These roles are:

- To provide fair and orderly trading markets
- To provide disclosures to investors
- To exercise oversight over fiduciaries and quasi-fiduciaries

THE OUTSIDE PASSIVE MINORITY INVESTOR MARKET IS BETTER INFORMED THAN ANY INDIVIDUAL INVESTOR

Value investing is useless unless practitioners assume that for their purposes, they are better informed than the OPMI market. This is not an unrealistic assumption, since most passive value investors are long-term buy-and-hold investors. Short-run market considerations, the lifeblood of the EMH, are unimportant in value investing. It is not that the value analyst has access to superior information *vis-à-vis* the OPMI market but rather that the value analyst uses the available information in a superior manner.

MARKETS ARE EFFICIENT OR AT LEAST TEND TOWARD AN INSTANTANEOUS EFFICIENCY

Efficient markets are a fundamental precept of the EMH. In value investing, all markets tend toward efficiency. Occasionally, there are markets, like the OPMI trading market that tends strongly toward instantaneous efficiency. Insofar as a market is characterized by instantaneous efficiency, there is no argument between value investing and academic finance, but most markets do not seem close to obtaining instantaneous efficiency most of the time. Because this is so, there is actually a wide chasm between MCT and value investing even granting a universal tendency toward efficiency in all markets. In many markets (e.g., mutual fund management fees or top management compensation in many public companies), the tendency toward efficiency seems so weak that it might be realistic to ignore it.

SUMMARY

There are substantive differences between academic finance as embodied in the efficient market hypothesis (EMH) and modern capital theory (MCT), and fundamental finance (FF) in general, and value investing in particular. We provide an exhaustive discussion of each and every substantive difference pointing out the narrower and more limited focus of the academic finance approach to investment problems.

* This chapter contains original material, and parts of the chapter are based on material contained in Chapter 2 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman), and ideas contained in the 1999 1Q, and 2003 2Q letters to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ See the work of Professor Edward I. Altman as a prime example of this school of thought.

² William F. Sharpe, *Investments: An Introduction to Analysis and Management*, Third Edition (Englewood Cliffs, NJ: Prentice Hall, 1985).

³ See Chapter 14.

⁴ “Volker Rule Could Prove to Be ‘Devastating’ for Munis,” *Investment News*, March 13, 2012.

⁵ As of February, 2012. Data from the Closed End Fund Association.

⁶ Richard Brealey and Stuart C. Myers, *Principles of Corporate Finance*, Fourth Edition (New York: McGraw-Hill, 1991).

⁷ Thomas E. Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* (McKinsey & Company, Hoboken, NJ: John Wiley & Sons, Inc., 1992).

CHAPTER 18

Broker-Dealer Research Departments and Conventional Money Managers*

How Research Departments and Conventional Money Managers Think Problems Faced by Research Departments and Conventional Money Managers Summary

In November 1998, Toyoda Automatic Loom Works, Ltd. (since renamed to Toyota Industries) common stock, listed on the Tokyo Stock Exchange, appeared to be a good example of a common stock that was safe and cheap based on “what is” because the company was well financed and represented a way of buying into the common stock of Toyota Motor, a blue-chip automotive manufacturer at a discount of perhaps 35 to 40 percent. Toyota Industries common was trading at about 2,300 yen per share, or about \$16.5 to \$17 U.S. dollars. Its adjusted balance sheet, expressed in U.S. dollars, was as shown in [Table 18.1](#).

Table 18.1 Balance Sheet for Toyota Industries Corporation (Adjusted NAV in \$000s)

	6.0×	8.0×	Per Toyota Industries Share*	
			6.0×	8.0×
Operating income: \$251,570	\$1,509,420	\$2,012,560		
Less: nonconvertible funded debt	\$259,917	\$259,917		
Fixed multiple going concern equity value	\$1,249,503	\$1,752,643	\$3.97	\$5.56
192,725 shares of Toyota Motor common @ \$25/share	\$4,818,125	\$4,818,125	\$15.30	\$15.30
Remaining portfolio of marketable securities at market 11/13/98	\$1,990,129	\$1,990,129	\$6.32	\$6.32
NAV appraising Toyota as a closed-end investment company	\$8,057,757	\$8,560,897	\$25.59	\$27.18
Discount from NAV at market price of \$16.59 for Toyota Industries common			35%	39%

* Adjusted shares outstanding, 315,000; Toyota Industries Corporation share price @ 11/13/98, \$16.59; exchange rate, 122.65 yen to the dollar.

Research department analysts and conventional money managers probably would have had no interest in Toyota Industries common stock in November 1998 unless they had some evidence that would have led them to believe:

1. That there would be a dramatic improvement in reported earnings for Toyota in the current fiscal year.
2. That some action might have been imminent, such as an acquisition of Toyota Industries by Toyota Motor, which would result in a workout value for Toyota Industries common at a substantial premium over November 1998 market prices.
3. That the outlook for common stock prices on the Tokyo Stock Exchange (TSE) was quite bullish.

Moreover, in December 1995, research department analysts and conventional money managers probably would have concentrated on having an opinion as to the probability that Kmart would seek Chapter 11 relief. Analysts who thought Kmart was likely to seek Chapter 11 relief would have avoided acquiring Kmart debt even if they believed that the ultimate workout in a reorganization would be not less than 100. They would have focused on the belief that if Kmart did file for Chapter 11 relief, the market price of Kmart debt would decline, probably dramatically; for those analysts, the time to acquire Kmart debt would have been after a Chapter 11 filing, not before.

In previous chapters we discussed the characteristics and limitations of the recommended approach of value investing, the characteristics and limitations inherent in the efficient market hypothesis (EMH) and all other academic approaches, and the characteristics and limitations of fundamental analysis as promulgated in the works of Benjamin Graham and David Dodd and their predecessors. In view of the endless reports put out by Wall Street research departments and the

countless presentations, both written and oral, made by conventional money managers, it is instructive to look at the analytic approach that most research departments and conventional money managers follow. This chapter serves two purposes: First, it describes the analytic techniques that are followed by research departments at most broker-dealers—the sell side—and also by most money managers responsible for the noncontrol passive investing of funds entrusted to their care—the buy side. Second, it discusses the limitations—problems—inherent in usual research department—conventional money manager approaches.

HOW RESEARCH DEPARTMENTS AND CONVENTIONAL MONEY MANAGERS THINK

Research departments and conventional money managers seem to follow a strict going concern approach. A firm is analyzed only as a going concern to be operated in the future pretty much as it has been in the past, in the same industry it has always been in, and financed as it has been financed traditionally. The market value of common stocks is deemed to be determined by future reported earnings, cash flows, or both, appropriately capitalized. A weight of almost 100 percent is given to this going concern approach, one that is forward looking because it impinges on financial statement analysis. It emphasizes a primacy of the income account unmodified by considerations of the current quality of either a corporation's financial position or the net assets the company employs. Indeed, both high-quality assets and large net assets, or book values, tend to have negative connotations for valuation purposes for many research department/money manager analysts. A strong financial position indicates to these analysts that management has not employed assets as aggressively as they might. A high book value, too, tends to be a negative because such numbers, *a priori*, spell lower returns on equity (ROEs) and returns on assets (ROAs) than would otherwise be the case. Put otherwise, the strict going concern approach of research department analysts and conventional money managers seems to view financial factors that are thought of as positives in a resource conversion approach or value investing approach (i.e., strong financial positions and high asset values) as either a negative or unimportant.

Research department analysts and conventional money managers tend to believe that their objective is to estimate prices at which a security might sell at a future date in the outside passive minority investor (OPMI) market. When consideration is given to underlying corporate values, it is not these corporate values, *per se* that count but rather how much, if at all, the underlying corporate values ought to fit into the estimate of future prices in OPMI markets. Other considerations in the estimation of market prices include dividend policies; technical chartist market considerations, including supply and demand for securities; industry outlooks; opinions about general market levels, interest rates, and gross domestic product (GDP) growth; insider buying and selling; and Wall Street sponsorship.

Research department analysts and conventional money managers tend to be tremendously influenced by short-run corporate revenue and earnings reports. As part of estimating market prices, they tend very much to be trend players, especially on the buy side, refusing to acquire securities if they believe near-term outlooks for prices are unfavorable. As part of being short-run conscious, research departments and conventional money managers tend to place much greater weight on the prospects that the development of a catalyst might result in common stock price appreciation than on the acquisition of securities solely because the price appears, on the basis of statistical considerations, to be cheap. They see a trade-off between catalysts and low prices in OPMI markets. The more likely that a catalyst will come into existence, other things being equal, the higher the price at which the common stock will sell. After all, OPMI markets, like all markets, do tend toward efficiency even though those efficiencies can be quite weak at times.¹ For many research departments and conventional money managers, low price alone is not a sufficient condition for making a securities purchase. Rather, the essential condition for the purchase is the

perception of a relatively near-term catalyst that will result in price appreciation, whether that catalyst is embodied in prospects for improved earnings, for earnings in excess of consensus forecasts, or for such a transaction as a merger and acquisition (M&A), a major refinancing, or a liquidation.

For research departments and conventional money managers, a common stock tends to be deemed to be cheap statistically if price-to-earnings (P/E) ratios (or price-to-cash flow ratios) seem modest relative to comparables. The earnings (or cash flow) figures used for these P/E ratio calculations are the most recent reported earnings, the earnings forecast for the period just ahead, or both, with the period just ahead being either the next quarter or the next 12 months. Rarely are other measures of being statistically cheap used; when they are, the tendency is to not give them much weight. Other measures of being statistically cheap might include price-to-net asset value (NAV) ratios, in which NAV is determined by reference to either book value or appraised value, and price-to-average annual earnings ratios for the last three or five years.

Research department analysts and conventional money managers tend to be very conscious of comparative analyses. They give great weight to a comparison between quarterly earnings as actually reported and consensus estimates of quarterly earnings and consider intra-industry comparative revenue and earnings performance to be important. Many also attach material significance to growth trends compared to P/E ratios. For example, assuming a company's earnings per share are forecasted to grow at 30 percent compounded, a P/E ratio of 30 times is justified; 25 percent growth would justify a P/E ratio no greater than 25 times. This is called growth at a reasonable price (GARP)² and gave rise to what analysts call the PEG ratio; that is, the ratio of the P/E ratio and the expected growth rate in earnings.³

In using analytic techniques, research departments and conventional money managers rely much more heavily on fieldwork (e.g., management interviews) than they do on intensive document reviews (e.g., in-depth analysis of audited financial statements or of court records).

Of the vast majority of research department reports in recent years, only a very few seem to provide excellent underlying analyses that are helpful for value investing. The thrusts of virtually all the reports, both the excellent and the not so excellent, are as follows:

- Estimate future earnings per share (EPS), earnings before interest, income taxes, depreciation, and amortization (EBITDA), or both. At the end of 2011, such estimates would be done by years for, say, 2012, 2013, and 2014.
- Apply to those EPS and/or EBITDA estimates an appropriate P/E ratio or EV to EBITDA ratio based on the following:
 - Industry identification
 - Growth trend
 - Other factors, such as management appraisal, sponsorship, return on equity, or economic value added (EVA)

Almost 100 percent weight tends to be given to this approach—estimating future flows, whether cash or earnings, and applying an appropriate capitalization rate to these estimated flows to arrive at a target price for a common stock. A change in quarterly earnings estimates is deemed to be very important news and very frequently results in a change in the target price.

Research department analysts almost never recommend outright sales or selling short. Many conventional money managers sell frequently—when they believe that a security does not have short-run appreciation prospects or that an alternative commitment has better short-run appreciation possibilities.

PROBLEMS FACED BY RESEARCH

DEPARTMENTS AND CONVENTIONAL MONEY MANAGERS

The Difficulty of Forecasting Earnings

For most companies in most industries, it is very difficult to predict future revenues and earnings and cash flow results. Future events have always resulted in large numbers of such forecasts' being plain wrong. Traditionally, there have been industries in which such forecasts could be made with reasonable accuracy (e.g., integrated electric utilities or real estate properties benefiting from long-term leases to creditworthy tenants). For most other companies, though, predictions frequently will be in error by relatively wide margins whether those companies are automobile assemblers, aluminum producers, semiconductor equipment manufacturers, health-care providers, bank lenders, pharmaceutical firms, retailers, building product suppliers, or, as a matter of fact, just about any kind of U.S. corporation.

When research department forecasts prove to be overly optimistic, as many do, the analyst often has no anchor to windward, as would exist were the shares recommended on some other basis than merely estimates of future flows. One such other basis, rarely relied on by research departments and conventional money managers, is the acquisition of common stocks when those issues are selling at prices representing some sort of reasonable relationship to NAV. Another such basis is the restriction of common stock investments to businesses that enjoy strong financial positions so that the company will have staying power, possible comeback ability, and no likelihood of defaults on corporate debt obligations, in the event that future results are much worse than the analyst's forecast.

Ameliorating to some extent this lack of an anchor is the fact that research department analysts and conventional money managers tend to be traders, not investors. Losses can be cut by early sales, especially if securities holdings are confined to relatively marketable issues. Trading, though, does tend to limit prospects for super-long-term profits, whether realized or unrealized, available to those following a buy-and-hold strategy.

The Competitiveness of Conventional Analysis

Attempting to forecast future flows and applying an appropriate multiplier thereto is an extremely competitive activity within the financial community. There are probably thousands of analysts, on both the sell side and the buy side, trying to do pretty much the same thing, and many are very bright and diligent.

The Likelihood That It Is Impossible to Do Top-Down Analysis Rationally

Although predicting EPS and EBITDA for companies may be difficult, predicting the P/E ratios that might be assigned to that EPS or EBITDA in a future OPMI market may well nigh be impossible. Making forecasts about future general OPMI market levels probably is much more in the realm of abnormal psychology than of fundamental finance. There is no evidence that the general market and large sectors within it are governed by any price behavior other than a random walk. Put otherwise, no one really predicts market levels accurately. Indeed, it is probable that no one really can identify those macro factors likely to influence OPMI market prices, and the weights that might be assigned to each factor.

For many analysts, too, including G&D, predicting future earnings for a company starts with

top-down estimates of the outlook for the general economy, for interest rates, and for inflation. Historically, making accurate estimates about these macro factors has been hard to do.

Being unable to predict the levels or direction of general markets is ameliorated to a considerable extent, for conventional money managers with a modicum of intelligence, through diversification. Thus, if forecasts of EPS or EBITDA come through for a good percentage of the companies in a portfolio of common stocks, that portfolio ought to perform satisfactorily (certainly in comparison with other portfolios) regardless of what happens in the general market. All bets about ability to withstand market drops are off, however, for those money managers who operate with borrowed money.

With highly leveraged portfolios, money managers had better be right, or close to right, about future market prices a good deal of the time. Fortunately, in the field of institutional equity investment, most portfolios are not highly leveraged, whether they are the assets of investment companies (e.g., mutual funds), or defined benefit pension plans, or of insurance companies.

Fighting for the Heavyweight Championship with One Hand Tied behind Your Back: Predicting Future Earnings while Ignoring the Existing Balance Sheet

Analysts who focus on trends tend to think linearly: the past is prologue; therefore, past growth trends of EPS or EBITDA will continue into the future or even accelerate. The truth, however, is that the corporate world is rarely linear.

The fact is that for many—if not most—companies, analysis of the amount and quality of resources that a management has to work with is as good as or an even better tool for predicting future EPS or EBITDA than is the past earnings record. It appears most research department analysts and money managers ignore this tool, especially when it indicates a strong financial position. This is true even though theoretically, no analyst interested in ROE and ROA can safely ignore equity or assets, both of which are balance sheet items. Improved returns, if applied to larger equities and assets, will give securities investors a much bigger bang. The elementary fact is that both the past earnings record and the present balance sheet are good and frequently necessary tools for predicting future flows for many companies.

It is much easier for a management to improve returns if the company has a strong financial position with which to work. A prime example of this was Nabors Industries, an oil service company with which the senior author has been associated for many years. Nabors emerged from a prepackaged Chapter 11 reorganization in mid-1988 with an all-equity capitalization. At that time, Nabors was virtually the only contract driller not burdened by large amounts of debt incurred during the pre-1983 boom time in the oil drilling industry. Given its financial strength, Nabors was able to spend the next few years acquiring contract drillers and contract drilling assets at bargain prices; other industry participants did not have the financial wherewithal to bid against Nabors for these assets. In 1987, Nabors's cash loss from operations probably was in excess of \$20 million; in 1997, Nabors's positive cash flow from operations was well in excess of \$200 million and in 2011 it was close to \$1.5 billion.

The earnings record and the present balance sheet are both helpful tools for predicting future earnings, but one is not a substitute for the other. Which of the two ought to be more important in any given situation is a matter of analytic judgment. Giving blanket priority to income account considerations and thereby denigrating the importance of balance sheet items, however, seems to disadvantage many research department analysts and conventional money managers because they ignore qualitative and quantitative balance sheet data as sources for estimating future flows, whether cash or earnings.

Lack of Awareness of the Relationship between

Income Account Numbers and Balance Sheet Numbers and of Analytic Conflicts between and among Related Numbers

When analysts focus only on forecasting future earnings and do not take into account balance sheet considerations, as is the case for many research departments and conventional money managers, there is no need to examine the relationship between income accounts and balance sheets. When they instead look at present balance sheets as either a helpful tool for predicting future earnings or as a margin of safety in case earnings forecasts do not work out, the relationships between the income account numbers and balance sheet numbers become important—and sometimes result in analytic conflicts.

EXAMPLE

Assume that an analyst is seeking a margin of safety for a common stock holding by having the recommended stock sell at a price that is in a reasonable relationship to NAV. It will be impossible to obtain that margin of safety if the common stock in question sells at a high P/E ratio and the company enjoys a much above average ROE. Say that XYZ common sells at 30 times earnings and that XYZ's ROE is 20 percent. Then, *a fortiori*, XYZ common will trade at 6 times NAV. (XYZ earns \$1 per share, making the price of XYZ common 30; an ROE of 20 percent on earnings of \$1 results in an NAV of \$5 per share; \$5 NAV divided into 30 price equals a price to book ratio of 6 times.) Research department analysts and conventional money managers interested in companies that they perceive to be rapidly growing and also that earn high ROEs had better ignore the margin of safety that could be inherent in the price of a common stock being close to NAV if they are going to opt for growth and high ROEs.

Furthermore rapidly growing earnings in past years mean that average earnings for those past years are less than they would have been had earnings grown less rapidly. Thus, growth investors tend not to look for any margin of safety that might be inherent in a common stock selling at a price that represents a

relative modest P/E ratio based on average annual earnings for a past period.

The following table presents the earnings per share of a rapidly growing company:

Year	EPS
1	\$1.00
2	\$2.00
3	\$3.00
4	\$4.00
5	\$5.00
Average earnings	\$3.00

Suppose the common stock sells at 10 times year 5 earnings of \$5.00 per share, or \$50. The issue also would be selling at 16.7 times five-year average earnings.

It should be noted that the fact that the relationship also works the other way is not particularly relevant for most research department analysts and conventional money managers. The trade-off between high P/E ratios and high ROEs on the one hand and reasonable prices relative to NAV on the other hand functions in such a way that an analyst wanting to focus on common stocks selling close to NAV will not be able to invest in common stocks when the issue is selling at a high P/E ratio based on current earnings and the company enjoys an above-average ROE.

EXAMPLE

Assume Company XYZ has a NAV of \$10. ROE is 20 percent, which means that earnings per share are \$2. If XYZ common stock sells at 20 times earnings, the price in the OPMI market would be \$40 or four times NAV.

It is quite feasible to acquire common stocks at prices closely related to present NAV and at low P/E ratios based on what a corporation's earnings are likely to be when current difficulties, which are depressing current earnings and earnings forecast for the period just ahead, are overcome. The OPMI market, though, tends to be too efficient for there to be many opportunities to acquire securities when both prices are reasonable relative to present NAV and the P/E ratios are low relative to current earnings and immediate future earnings. Analysts and money managers focused on current earnings, forecasted earnings for the period ahead, and ROE must virtually ignore price as related to NAV. As a matter of fact, they do ignore NAV. Given the inaccuracy of most forecasts, however, they do so at their own peril.

Use of an Approach Antithetical to Those Used by Private Businesspeople and Control Buyers Not Seeking Immediate Access to Equity Markets for New Capital

The basic objective of private business people and control buyers is to create wealth (and sometimes cash flows for themselves) in the most efficient manner, which usually involves following courses of action that minimize the present value of corporate income taxes payable. Research department analysts and conventional money managers have the opposite agenda: They want corporations whose common stocks they are holding or recommending to report maximum amounts of near-term earnings from operations, earnings that tend to be currently taxable at maximum tax rates.

They also desire companies whose common stocks they are recommending to be short-term oriented. In their view, managements ought to forgo projects with possible huge long-term pay-offs if that entails sacrifices in creating near-term operating income. Given their druthers, most managements not seeking near-term access to equity markets probably would opt for the long-term view of wealth building.

Research department analysts and conventional money managers also tend to be more interested in what the numbers are, especially earnings per share, rather than what the numbers mean.

Furthermore, given the emphasis on a going concern approach to analysis, analysts and money managers tend to want the companies whose common stocks they are recommending to have a single industry focus, at least in 2012. They view those companies as operations rather than as converters of resources to other, and possibly higher value uses. If companies diversify into other industries, they no longer are seen as pure plays—they are harder to follow.

Many good managements, left to their own devices, would view the companies they control as both going concerns creating operating profits and resource conversion vehicles creating wealth by investing in different and sometimes even unrelated industries.

The current anathema of research department analysts and conventional money managers to corporate diversification does have considerable long-term merit. Too many companies have suffered because of diversification into industries not well understood by managements. Nonetheless, analysts' apparent distaste for diversification contrasts with what many managements would like to do provided that they do not find it necessary or desirable to placate Wall Street.

Analysts and money managers also tend to use different approaches to analysis than do control buyers of corporations. Rather than focus on a strict going concern approach with an emphasis on near-term operating results, business buyers, such as leveraged buyout (LBO) specialists, tend to concentrate on three issues:

1. How can a transaction be financed?
2. What is the long-term outlook for the business?
3. What are the various exit strategies that might be available?

The Lack of a Balanced Focus, Resulting in Common Stock Prices that Are Much Too High or Much Too Low

By concentrating almost exclusively on earnings or cash flow forecasts and capitalization rates, analysts have no safety net when prices get way out of line. There is a strong tendency for prices in OPMI markets, both high and low, to have elements of irrationality that do not exist to anywhere near the same extent in negotiated transactions between reasonably knowledgeable buyers and

sellers. In negotiated transactions, there is a tendency to consider and weight a whole gamut of factors in arriving at a transaction price, rather than just applying a capitalization rate to current earnings (or cash flow) and predictions of earnings (or cash flow) for the immediate future.

Given access to capital markets, though, an overpriced stock can be an important asset for a corporation run by a management with skills in M&As. See example that follows.

Analyses That Focus on Base Case Forecasts Rather than Alternative Scenarios

An investor putting \$100 million or more of his or her own funds into an equity situation in which the funds will be tied up on a permanent or semipermanent basis usually does not rely as heavily on base case forecasts as do research department analysts and conventional money managers. This is understandable because the latter groups enjoy marketability and can, at least theoretically, undo investments rapidly. One consequence of this, though, is that there is far less need and desire for research department analysts and conventional money managers to conduct in-depth investigations: Given high portfolio turnover, it becomes terribly unproductive to do in-depth investigations. Furthermore, it becomes impossible for even the largest organization to conduct in-depth investigations when the number of securities in a portfolio runs to hundreds of issues.

EXAMPLE

The market price of a common stock can be enhanced by using the security in mergers, especially when analysts concentrate solely on P/E ratios, as in this sample scenario:

XYZ common sells at 60, or 60 times earnings of \$1 per share, or \$10 million on 10 million shares outstanding.

ABC earns \$3 million.

XYZ acquires ABC in a transaction by issuing 800,000 shares of XYZ common, which would have a market value of \$48 million.

The post-merger income account is shown in [Table 18.2](#).

Table 18.2 The New Income Account

Variable	Value (000)
Net income	\$13,000.00
Number of shares outstanding	10,800
Earnings per share	\$1.20
Price-to-earnings ratio at price of 60	50.0x

If the normative P/E ratio is 60, post-merger XYZ

common should sell not at 60 but at 72.

By contrast, large investors holding equities on a permanent or semipermanent basis tend to investigate relatively thoroughly on two bases: the base case and the reasonable worst case. Most also put the optimistic case into the investigations mix.

External Pressures That Can Compromise Analyses

Research departments of broker-dealers that also have an investment banking presence can face pressures to recommend the common stocks of investment banking department client companies, especially those whose public issues were underwritten by the firm. Sometimes, even if only in a small minority of instances, these recommendations are based more on the good of the firm rather than the good of the client. Money managers frequently are under pressure from their firm's marketing department to undertake portfolio window dressing. Probably the most common scenario is that good marketing may require that the portfolio consist largely of the most popular issues, instead of emphasizing issues that, although less popular, are more attractive fundamental values.

The Difficulty of Concentrating on Operating Ratios Based on Financial Accounting Statistics

Given their emphasis on viewing companies strictly as going concerns, research department analysts and conventional money managers tend to place great worth on the analysis of operating margins—gross profit margins and operating income margins. This type of analysis has limited usefulness in many industries because the data are derived from short-form (i.e., no detail by specific items) financial statements, rather than long-form corporate cost, or managerial, accounting data. For most companies, if analysts do not have access to cost-accounting data, it becomes extremely difficult to understand the nitty-gritty of operations. Profit-margin analysis based on financial accounting can be a helpful tool, but it is a limited one. Also, comparative numbers can be tricky.

EXAMPLE

Company ABC and company XYZ each have operating income of \$1 million from conducting the exact same activities. ABC claims to have sales revenue of \$50 million, and XYZ, for the same activities, books consulting revenues of \$10 million. On the basis of these numbers, ABC's operating profit margin is 2 percent and XYZ's is 10 percent. Furthermore, ABC might treat, say, rent expense as a cost of goods sold, whereas XYZ might treat rent expense as an administrative or general expense, which would be a component of operating expense.

Heavy Reliance on Fieldwork to the Exclusion of Reading Documents

Reading the documents is no substitute for fieldwork—interviewing managements, competitors, customers, government regulators, and others who can contribute information to an analysis. The reverse is also true: Doing field work is not a substitute for carefully reading relevant documents—Securities and Exchange Commission (SEC) filings, stockholder mailings, court records, competitors' documents, and industry publications. Indeed, fieldwork and document reading go hand in hand. Those who read and understand document contents tend to be much more skillful at fieldwork than are analysts who ask questions before they have a good documentary background for asking those questions. Documents tend to be given short shrift, though, by many research department analysts and conventional money managers. In part, this is understandable: Much of what is in documents appears to have little relevance to predicting what near-term OPMI market prices will be, and reading documents is very time intensive, hardly worthwhile for those trading in and out of large numbers of securities in a portfolio. Finally, interpreting documents, especially financial statements, takes a fair amount of training; which many analysts seem to lack.

A principal problem for analysts who choose not to rely on documents they have intensely scrutinized, especially audited financial statements, is that many analysts involved in passive investing have been defrauded or otherwise victimized, by promoters selling stories with no hard-nosed backup. This was true for public holders of U.S. corporate bonds before the Trust Indenture Act of 1939, true in the 1960s when small companies went public, true in the 1970s and 1980s when tax-sheltered limited partnerships were all the rage, true in the 1990s for analysts recommending common stocks of companies in emerging markets with virtually nonexistent document disclosure requirements, and true in the 2000s when institutions bought AAA rated residential mortgage-backed securities.

Heavy Reliance on Perceptions of What Others Think

All rational analysts involved with passive noncontrol investing are probably influenced to some extent by what they perceive are the opinions of insiders or smart money. For example, if insiders and 10 percent shareholders are selling common stock, that is a factor to put into the mix of information. That information becomes far more meaningful, though, when it becomes a supplemental part of the buy-and-hold analyst's independent judgment about what the firm might be worth or what future dynamics for that firm might be. Depending on the individual situation, insider selling might mean on the one hand that a security is overpriced or, on the other hand, that the company is now a more attractive takeover candidate, in part because insider-owned blocks of stock can be purchased or otherwise tied up. The analyst is unlikely to be able to make good judgments on this issue without having independent opinions about corporate values and dynamics.

A rationale for relying solely on perceived opinions of insiders and smart money is that the analyst's sole goal is to predict the prices at which a security will sell in the immediate future. If you are going to try to predict near-term prices, you had better focus on what you believe influential others think: buy and sell recommendations of major research departments, consensus forecasts of quarterly earnings, and insider trading. This in fact seems to be what a lot of research department analysts and conventional money managers do, especially those with no interest or little training in fundamental analysis. Relying heavily on the perceived opinions of others, to the exclusion of independent fundamental analysis, seems a tough way to make a living, though.

The focus of broker-dealer research departments and money managers may be helpful in predicting near-term market prices. However, this same focus tends to mislead in imparting deep understanding of a business and the securities it issues. Such deep understanding is essential for OPMIs interested in long-term investments; for control investors; for most distressed security investors; and for credit analysis. It seems to us that these misperceptions arise out of an overemphasis on four factors:

1. A belief in the primacy of the income account and a consequent

downgrading of balance sheet-related elements. This belief rests on a myopic view of how businesses generate wealth.

2. A belief in equilibrium pricing. It is believed that price changes occur only as the market receives new information. The price of a security is always right, and securities, therefore, are never overpriced or underpriced in OPMI markets.

3. An overemphasis on top-down factors and a consequent downgrading of bottom-up considerations.

4. An emphasis on short-termism. This bias is a natural consequence of all the above beliefs.

SUMMARY

In summary, there are huge problems involved in obtaining satisfactory long-term performance by following what appear to be the basic precepts of research department analysts and conventional money managers. Both value investing and the teachings of Benjamin Graham and David Dodd also have problems. Nonetheless, it appears much easier and basically much more productive to adhere to value investing standards rather than research department and conventional money manager approaches. Still, it is obvious that some—though probably a substantial minority of—portfolios run by conventional money managers perform quite satisfactorily on average and over the long term. This can be attributed to the fact that many money managers are very smart. Even so, what even the best conventional money managers do seems to be the hard way to achieve satisfactory results compared with the results of analysts who lean more toward value investing.

* This chapter contains original material and material contained in Chapter 4 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman). This material is reproduced with permission of John Wiley & Sons, Inc.

¹ See Chapter 14.

² The concept appears to have been popularized by Peter Lynch in his 1989 *One Up on Wall Street* (New York: Fireside, 1989).

³ This ratio was developed by Mario Farina in his book *A Beginner's Guide to Successful Investing in the Stock Market* (Palisades Park, NJ: Investors' Press, 1969).

Part Three

Real-World Considerations

CHAPTER 19

Uses and Limitations of Financial Accounting*

The Conventional Approaches

Financial Accounting Reports as Objective Benchmarks

Generally Accepted Accounting Principles as Defining Reality for Certain Specific Purposes

Generally Accepted Accounting Principles as a Road Map for Due Diligence and Less Thorough Investigations

Summary

Corporate reporting of “the numbers” has become so important, and so publicized, it might be helpful to our readers if we commented briefly about how we use and think about financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) and with International Financial Reporting Standards (IFRS). We are quite different from most others in how we make use of financial information.

First, financial statements are always of utmost importance in our analysis. This, perhaps, may be the most significant reason why we have never been involved with pure play Internet issues. Here, corporate numbers did not seem to count at all. The only important thing seemed to be to gauge short-term investor psychology—something to which we pay scant attention.

GAAP or IFRS figures can serve two different roles for outside passive minority investors (OPMIs):

1. First, an accounting number—usually earnings per share—is a tool to be used to help predict the price at which a common stock will sell in markets just ahead.
2. Alternatively, all accounting numbers—the whole bookkeeping cycle—are tools to be used to give an investor objective benchmarks, clues to aid him or her in understanding a business and its dynamics.

The vast majority of analysts seem to view GAAP or IFRS only in their first role, as tools to be used to help predict the price at which a common stock will sell in the period just ahead. The regulators, whether governmental as embodied in the Securities and Exchange Commission, or private as embodied in the Financial Accounting Standards Board, seem to share the same view wholeheartedly. Estimating the market impact of accounting numbers is what counts for them. Thus, for the majority of users of financial accounting there is a primacy of the income account.¹ There has to be as accurate a statement as possible of quarterly reports of income from operations; earnings before interest, taxes, depreciation and amortization (EBITDA); and earnings per share (EPS). The focus is on an income account, or flow, number with full attention paid to what the numbers *are*, as reported, rather than what the numbers *mean*.

We belong to the second school in our use of GAAP and IFRS. We believe that financial

accounts are essential tools giving analysts objective benchmarks, clues that will aid in understanding a business and its dynamics. In equity analysis, accounting cannot, and should not, be expected to tell real-world *truths*. Rather, the limiting assumptions of GAAP—for example, depreciation is based on original cost rather than current value—means that what the numbers *are*, are not what economic *truth* is. Many of the underlying assumptions of GAAP have to be unrealistic as for example property values are based on historic cost less periodic depreciation charges, rather than estimated market values for properties like in IFRS.² Additionally, if one wants to understand a business and its dynamics, one has to focus on a considerably greater number of factors than merely flows—whether income from operations, EBITDA, or EPS.

Equally important, and usually more important than flows, in a fundamental finance analysis, is the quality and the quantity of resources (relative to the price being paid for a common stock) existing in a business. Quality of resources and quantity of resources are essentially balance sheet, rather than flow, considerations.

Further, in a fundamental finance analysis, there is no primacy of anything such as earnings, but rather a realization that any number within the whole ball of wax can be important. Every accounting number is a function of, derived from, and modified by other accounting numbers. Moreover, there are no top-down rules for the use of GAAP that have universal applicability, contrary to what seems to be the case with conventional approaches. Rather, each accounting item is evaluated from the bottom up in specific contexts.

The analytical techniques that we use, while different from those that seem to be used by most money managers, seem to be quite similar to those used by most activist investors, or those interested in obtaining control of companies. For us, GAAP and IFRS reports serve three purposes:

1. To provide analysts with objective benchmarks, essential tools of analysis that analysts use to determine one or more economic realities or truths
2. To define reality for certain special purposes
3. To provide a road map for analysts both in due-diligence investigations and in less thorough investigations, in which analysts rely exclusively on public records

In this chapter we briefly discuss the conventional approaches to using financial accounting information first. We then discuss financial accounting reports prepared under GAAP or IFRS as objective benchmarks, not truth. For certain specific purposes, GAAP does define reality. We discuss these specific cases next. Finally we illustrate how either GAAP or IFRS provide a road map for due-diligence investigations and less thorough investigations.

THE CONVENTIONAL APPROACHES

The conventional roles visualized for financial accounting appear to be quite different from the roles accounting has in fundamental finance. Conventional approaches to financial accounting are those that seem to be followed by most broker-dealer research departments and most investment-company money managers. The conventional approach is endorsed also in the literature recommended in study guides for those seeking the designation chartered financial analyst (CFA). Three volumes make up the bulk of the CFA study guide literature covering financial statement analysis:

- *Fundamentals of Corporate Finance*, Third Edition, by Stephen A. Ross, Randolph W. Westerfield, and Jeffrey F. Jaffe (Irwin, 1995)
- *Investment Analysis and Portfolio Management*, Fifth Edition, by Frank K. Reilly and Keith C. Brown (Dryden Press, 1997)
- *The Analysis and Use of Financial Statements*, Second Edition, by Gerald I.

White, Ashwinpaul C. Sondhi, and Dov Fried (John Wiley & Sons, 1997)

The roles of GAAP under conventional approaches appear to be as follows:

- Accounting data should reflect the truth, or economic reality, to the maximum extent possible. The important figure for which truth is to be ascertained is the firm's periodic net income from operations, or other measures of a firm's performance during a period.
- The reaction of OPMI trading markets to the dissemination of accounting information as measured by OPMI market prices is a matter of crucial importance. The only market that counts is the OPMI market.

White, Sondhi, and Fried discuss, in Chapter 5 of their book, "Empirical Research: Implications for Financial Statement Analysis," the principal avenues followed in the conventional approach: the classical approach, market-based research, and positive accounting research.

They point out that the classical approach

attempts, using a theoretical perspective, to develop an optimal, or "most correct" accounting representation of some true (but unobservable) reality. (p. 216)

In describing market-based research, they wrote that

Its primary focus is the market reaction to (or association with) reported accounting data. Market based research uses observable relationships between reported earnings or other measures of firm performance) and market return to draw conclusions about the role of accounting information. (p. 216)

The "positive" accounting theory approach, they wrote, adapts much from market-based research but recognizes further that accounting information as reported defines reality for a whole gamut of non-OPMI market contexts, including

management compensation plans, debt agreements with creditors, and the host of regulatory bodies interacting with the firm. More important, it recognizes that since financial statements impact these other environments, there are incentives for accounting systems to be used not only to measure the results of decisions but, in turn, to influence these decisions in the first place. (pp. 216, 218)

The classical approach and market-based research seem based on the following underlying assumptions that have little or no validity from a fundamental finance point of view:

- Firms are strict going concerns and are to be appraised as such. Thus it follows that there exists a primacy of the income account and a consequent denigration of other elements that make up the accounting cycle. This makes sense because if a company is a strict going concern, the past earnings record ought to be the best tool for predicting future earnings.³
- Predicting prices for near-term OPMI trading markets is an analyst's primary or principal task. Thus, there exists a primacy of the income account. OPMI markets clearly seem to react more to current earnings per share reports than any other accounting number, especially balance sheet numbers for solvent corporations. This focus is the direct result of viewing businesses as pure going concerns.⁴
- Prices in OPMI markets are universal equilibrium prices that reflect all (or almost all) available present information. Prices will change as new information, both accounting information and non-accounting information becomes known.⁵
- *Market* is defined as the OPMI market. Other markets (e.g., the leveraged buyout [LBO] market) are ignored.
- The presence or absence of price volatility in OPMI markets is deemed

important for all investors, even buy-and-hold fundamentalists who do not finance their holdings using borrowed money.

In summary, the purposes and uses of accounting in fundamental finance seem quite different from those in conventional approaches. We view financial accounting as a tool to help analysts approximate:

- The performance of a business during a particular period
- The quality and quantity of resources existing in a company at any one moment

Over and above these factors, financial accounting is also a tool used to make judgments about many nonfinancial (i.e., nonnumeric) factors including:

- Appraisals of management
- Finding information about material documents such as
 1. Leases
 2. Loan agreements
 3. Pension plans
 4. Employment agreements

In conventional approaches, one key role of financial accounting, albeit not the only one, is to measure the true performance of a business during a period while emphasizing the reactions of traders to new accounting information as measured by changes in securities prices.

FINANCIAL ACCOUNTING REPORTS AS OBJECTIVE BENCHMARKS

GAAP is a system in which reports are made within a relatively rigid code whose descriptions of reality are limited because the underlying assumptions of the system frequently are unrealistic. Among the GAAP assumptions that are unrealistic in many contexts are that:

- Property, plant, equipment are to be carried at historical cost as depreciated.
- Constant price levels exist.
- Current assets and long-term assets are to be defined in a standard, inflexible manner.⁶
- All accounts on the right-hand side of a balance sheet are either net worth or above-the-line equivalents of payables.
- Accrual concepts are to be used in most contexts in which costs and expenses are matched, even when such accruals are at odds with the cash experience of the company.
- Sometimes liabilities are burdened with a cost of money, and sometimes they are not.
- There exist no liabilities (e.g., deferred income taxes) that may have a large equity component.

Furthermore, even given the limited number of choices available to corporate managements under GAAP, none of those choices need reflect economic reality:

- Inventory accounting

- Accounting for long-lived assets
- On-balance-sheet and off-balance-sheet liabilities
- Accounting for long-term employee benefits
- Accounting for income taxes
- Accounting for business combinations

GAAP originally were designed as a system to report on the results and the position of a consolidated corporation as a standalone. In the late 1990s, there were trends designed to consolidate substantively reports of the company with stock-market measures pertinent to others. This was exemplified by proposals later turned into rules to charge a company's income account with the estimated value of stock options issued to employees. This seems utterly unrealistic because it assumes that the value of a benefit received by an employee to that employee equals the cost to the company of granting that benefit. It is a basic concept of fundamental finance that the company is a standalone constituency. The value of a noncash benefit to an employee ought not to be equated to a cost to a company. The corporation is a separate and distinct constituency from the corporation's stockholders in almost all contexts.⁷

Because GAAP imposes relatively rigid sets of rules and are overseen and reviewed by independent professionals who render opinions (public accountants), audited financial statements are often the only numeric reports available to security analysts that give them reliable, objective information prepared in a disciplined setting. GAAP are not truth or reality, but a tool analysts use to determine their own versions of truth. By contrast with GAAP, other numeric reports (e.g., investment bankers' opinions and appraisers' reports) often lack objectivity and independence. These other reports tend to be derived in settings lacking professional standards or disciplines, and the other professionals rendering them usually are influenced, sometimes heavily, by who has hired them and who is paying their fees and expenses. This does not seem to be the case, however, for the vast majority of independent audits.

As has been pointed out, reality tends to be one thing when a company is examined as a going concern but quite another when the same set of numbers is used, for resource conversion valuations.

EXAMPLE

For a going concern, retail inventories are anything but a current asset; a retail chain had better maintain or even increase its investment in inventory if it is going to remain in operation, because such inventory is a fixed, long-term asset. On the other hand, if the retail chain is to go out of business (resource conversion), inventory becomes a true current asset, convertible into cash over the next 12 months.

In the real world, why would anyone expect financial accounting to disclose truth or reality for most analyses? In fact, though, GAAP data seem to reflect economic reality in quite a number of special cases.

EXAMPLE

The balance sheets of investment companies registered under the amended Investment Company

Act of 1940 reflect reality based on valuing portfolios at OPMI market prices in accordance with GAAP.

Furthermore, it seems likely that for most credit analysis, GAAP are realistic enough. Here, GAAP are not used to value, *per se*, but rather to give analysts enough information to gauge the probabilities that a debt instrument will be serviced in accordance with its terms.

By contrast, and as is pointed by White, Sondhi, and Fried, “the ultimate objective of equity analysis is valuation” (p. 932). From a fundamental finance point of view, when analysts are interested in the quality of resources existing in a business, especially if they are evaluating a senior credit, the one crucial disclosure to them would not necessarily be corporate valuation but rather the existence—or nonexistence—of liabilities that might be equal to or senior to the credit instrument being evaluated. This latter information is readily disclosed in most audits.

As we have repeated *ad nauseam*, in fundamental finance the focus is most often on *what the numbers mean* rather than *what the numbers are*. Fundamental finance analysts do not expect GAAP numbers to reflect truth or reality; rather, they view GAAP numbers as raw materials to be used, so they adjust the numbers to approximate reality. Truth or reality is something to be determined by analysts, not by accountants who prepare financial statements in conformity with that relatively rigid set of limiting assumptions known as GAAP.

EXAMPLE

In examining the property, plant, and equipment accounts of a hotel-motel chain, mainstream analysts likely would look at depreciation as a noncash charge against the income account. By contrast, although value investors would view depreciation attributable to buildings charged against the company’s income account as being a noncash charge giving rise to cash flows from operations, they would likely view any depreciation charged against the company’s income account attributable to furniture and fixtures as being the equivalent of a current cash expense or expenditure. Put simply, well-maintained, well-located bricks and mortar do not suffer much if any economic depreciation, but furniture and fixtures decline in value because they are used daily and have to be replaced with relative regularity.

In almost any analysis, we will be interested in not only periodic results from operations but also the *quality* and *quantity* of resources available to the company whose common stock is being analyzed. We realize that every accounting number is derived from, is modified by, and is a function of all the other numbers that are part of the accounting cycle. Income-account numbers can be no more accurate or meaningful than balance-sheet numbers. Each group is derived from, is modified by, and is a function of the other. White, Sondhi, and Fried’s view that “the usefulness of the reported balance sheet for investment decisions is limited” (p. 933), seems to be in error from

our point of view. A more appropriate statement might be that the reported balance sheet and the income account are intimately related to each other for investment decision purposes but that the usefulness of the reported balance sheet for day-to-day or hour-to-hour stock-market trading decisions is much more limited than is the status of current or forecast income accounts.

When analysts want to forecast future earnings for a business relying on GAAP results, they frequently conclude that the quality and quantity of a business's resources at the end of a recent period may represent a better tool for predicting future results than does the past earnings record—even the earnings record of the very recent past. More importantly, neither present resources nor past earnings are tools to be used exclusively to forecast future earnings; both can and most often should be used in concert.

EXAMPLE

In early 1960, Society Corporation was a bank holding company based in Cleveland, Ohio. At that time, banks in general were earning between 8 and 12 percent of net worth annually. Society, with a net worth of about \$50 a share, was earning about \$1.50 a share from operations when it converted from a mutual savings bank to a commercial bank holding company in 1962. This equaled a return on net worth of only 3 percent. A market participant could reason with a fair degree of confidence that over time Society probably would be earning a return on its equity close to that which was being achieved in the commercial banking industry in general. At least, there did not appear to be any insurmountable problems preventing this. Furthermore, book value, too, would be steadily increasing. The anticipated results occurred; reported earnings increased year by year, and by 1966 operating earnings were \$5 per share on a year-end book value of \$62. The prediction of Society Corporation's future earnings could not have been based on the past earnings record. An examination of the asset values and the belief that such asset values would be used much the way other commercial bank holding companies used theirs were the basis for the earnings forecast.

We do not subscribe to a primacy-of-earnings approach to analysis, because we have observed that few if any businesses whose common stocks are widely held are in fact strict going concerns engaged in traditional day-to-day operations managed as they always have been and financed as

they always have been financed. We assume that very few companies will go as long as five years without being involved in mergers and acquisitions (M&A), restructurings, massive refinancings, changes in control, and liquidations in whole or in part.

When companies are not strict going concerns, management appraisals ought to assess managements not only as operators but also as investors employing and redeploying assets and also as financiers, who are financing and refinancing businesses.⁸ These investor appraisals are not possible for analysts focused strictly on that part of GAAP or IFRS concerned with reporting the results of operations, with emphasis only on recurring revenues and profits.

Although it is too much to expect GAAP or IFRS to report truth or economic reality for purposes of equity valuations, GAAP or IFRS are the basic tools needed for making judgments about the managements of most companies either as operators, investors, or financiers. For us the investment and financier functions tend to be much more important than the operating function even though operating skills are not usually divorced from investment skills. Nonetheless, one good investment deal can have more significance than 10 years of brilliant operations. Look at the histories of Berkshire Hathaway Inc. or Nabors Industries.

Market-based research is concerned exclusively with the trading environment in OPMI markets. In terms of GAAP, market-based research attempts to fathom how new accounting information is likely to affect OPMI prices. In following this approach, analysts miss much about the usefulness of financial accounting for equity evaluations in markets other than OPMI markets—say, LBO markets, or markets for venture capital investments, or markets for the senior debt of troubled issuers.

A numeric example of differential pricing for LBO markets compared with pricing in OPMI markets demonstrates that large amounts of real values tend to be missed by those who look to market-based research. Assume common stock XYZ is trading in the OPMI market at around 16, perhaps because XYZ's near-term earnings outlook is poor or because the market prices for companies in XYZ's industry sector are depressed. Assume further that a control buyer, relying in part on audited financials, believes that XYZ common is worth not less than 35 because:

1. XYZ has a favorable long-term operating outlook based on both base-case and reasonable worst-case forecasts.
2. The control buyer gauges that a strong ability exists to finance a transaction attractively grounded largely on perceptions that XYZ enjoys strong finances and might have certain assets that could be sold without interfering with going concern operations.
3. The buyer believes that various benefits, such as management salaries and fees, can be obtained.⁹

The control buyer then either makes a cash tender offer for XYZ common at 21 or else proposes a cash merger at 21 with a shell corporation set up for the express purpose of acquiring XYZ in a merger transaction. The control buyer group can consist of outsiders, incumbent management, or combinations thereof.

Market-based research focuses strictly on the arbitrage that would exist between the OPMI market price of 16 and the takeover price of 21 or perhaps slightly higher. The question asked in market based-research is how the OPMI market will react in terms of trading prices to the announcement (or leak) of a takeover at a price of 21. Market-based research would be completely oblivious to the use of accounting information by potential control investors and others to determine that XYZ common might have a takeover value of approximately 35. That analysis seems to be the strict province of fundamental finance investing. Indeed, the efficient market hypothesis (EMH), the father of market-based research, is concerned only with OPMI trading markets, ignoring completely long-term buy-and-hold fundamentalism.

The use of GAAP in fundamental finance is similar to the use of the Internal Revenue Code by skilled tax practitioners. Both the fundamental finance analyst and the tax practitioner are essentially translators. Both take relatively rigid reporting systems: GAAP and the revenue code, and using the rules embodied in those systems, convert them into something usable. For the fundamental finance analyst, the goal is to translate GAAP into something reflecting the economic realities pertinent to the business being examined. For the tax practitioner, the goal is to translate

the revenue code so that the present value of taxes payable by clients is minimized. For example, tax professionals attempt to report as tax-deductible losses those items that have economic profits built into them; the well-maintained bricks and mortar owned by the hotel-motel chain cited previously may in fact appreciate in value over time, yet depreciation charges against the bricks and mortar are tax deductible. The skilled income tax professional does not seek economic truth but uses, to the extent permitted by the revenue code, accelerated depreciation methods, shortened lives, and minimal salvage values in charging the income account prepared for tax purposes with depreciation deductions for the buildings owned by the hotel-motel chain. We on the other hand, take the depreciation figures used for tax purposes and try to translate those figures, overstated in terms of economic reality, into economic reality.

When an analyst is dealing with what the numbers mean, what is important is only that items be disclosed. There is no emphasis whatsoever on where and how items are disclosed. This is antithetical to all conventional approaches, in which the perceived primary goal of financial accounting is a statement of periodic income from operations that is as correct as possible. Subscribers to this conventional view of the role of GAAP include academic finance, Graham and Dodd fundamentalists, and accounting authorities ranging from the Financial Accounting Standards Board (FASB) to the Securities and Exchange Commission (SEC). Since the 1970s, however, accounting disclosures have improved so much, that it is hard to complain merely because accounting authorities give much time and attention to the form in which accounting data is disclosed rather than to substantive disclosures. The fact is that improvements since the 1970s in the quality and quantity of substantive accounting disclosures have also been dramatic.

Important goals in the conventional approach are that accounting statements exhibit comparability and consistency. More important than comparability and consistency, when financials are viewed as objective benchmarks, is reconcilability. Analysts ought to be given enough information so that they can make financial statements comparable and consistent for their analyses.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AS DEFINING REALITY FOR CERTAIN SPECIFIC PURPOSES

When using GAAP as an objective benchmark, what the numbers *mean* is most often far more important than what the numbers *are*. GAAP numbers as reported more often than not do not reflect economic reality, but this is far from always the case. Good fundamental finance analysts are always aware of those instances in which the GAAP numbers actually do define certain realities—in which what the numbers *are* actually does become more important than what the numbers *mean*. This section of the chapter reviews those special circumstances when the reported accounting numbers define economic reality, legal reality, or both:

- **The OPMI trading environment.** Here, one reported number—EPS quarter by quarter—seems to define reality, especially in relation to when that EPS number equals, exceeds, or falls short of consensus forecasts.
- **Those times when corporations or insiders are seeking access to capital markets to sell equity issues.** In these instances, and from the points of view of the corporation and insiders who might sell, reported EPS usually have a big influence not only on the price at which an equity issue might be marketed but also on whether the issue can be marketed at all.

- **Tests as to whether corporations are meeting loan covenants, requirements, or other contractual requirements.** These figures are usually based on reported GAAP results. Such results typically cover many things other than EPS, including minimum net worth, EBITDA to debt ratios, earnings' coverage of interest, cash flow coverage of debt service, stock-to-debt ratios, and working capital ratios.
- **Capital adequacy tests for regulated financial institutions.** These usually deal in GAAP numbers as reported or in codified adjustments to GAAP numbers. This is the case for depository institutions, insurance companies, and broker-dealers.
- **Rating agencies.** These rely a great deal on reported GAAP financials.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AS A ROAD MAP FOR DUE DILIGENCE AND LESS THOROUGH INVESTIGATIONS

Audited financials, interim financials, and the management discussion and analysis (MDA), available either in company Internet postings or SEC filings, provide a comprehensive disclosure framework that enables a fundamental finance analyst to understand much about most—but far from all—businesses and the securities, both credit and equity that they issue. Financial statements cover the accounting cycle through the balance sheet, the income account statement, the statement of cash flows, and the statement of stockholders' equity, all as supplemented, especially in annual audits by footnote disclosures and the independent accountant's opinion. The MDA, issued quarterly and unaudited, is required to discuss the following:

- Results of operations, including trends in sales and categories of expense
- Capital resources and liquidity, including cash flow trends
- Outlook based on known trends

A convenient way to get a handle on all of the types of information disclosed under GAAP is to examine the table of contents of the 2012 edition of the *GAAP Guide: Interpretation and Application of Generally Accepted Accounting Principles*, by Steven M. Bragg (John Wiley & Sons):

Generally Accepted Accounting Principles ***Presentation of Financial Statements***

- Discontinued operations
- Balance sheet
- Statement of shareholders equity
- Comprehensive income
- Income statement
- Statement of cash flows
- Notes to the financial statements

Various Financial Reporting, Presentation, and Display Matters

- Accounting changes and error corrections
- Changing prices

- Earnings per share
- Interim reporting
- Limited liability entities
- Risk and uncertainties
- Segment reporting

Transaction-Related Topics

- Cash and cash equivalents
- Receivables
 - Nonrefundable fees and other costs
 - Loans and debt securities acquired with deteriorated credit quality
 - Troubled debt restructurings by creditors
- Investments—debt and equity securities
- Investments—equity method and joint ventures
 - Partnerships and unincorporated joint ventures
- Investments—other
 - Investments in insurance contracts
 - Beneficial interests in securitized financial assets
- Inventory
- Deferred costs and other assets
 - Capitalized advertising costs
 - Insurance contracts that do not transfer insurance risk
- Intangibles—goodwill and other
 - Goodwill
 - General intangibles other than goodwill
 - Internal-use software
 - Website development costs
- Property, plant, and equipment
 - Real estate sales
- Liabilities
 - Extinguishment of liabilities
 - Insurance-related assessments
- Asset retirement and environmental obligations
 - Asset retirement obligations
 - Environmental obligations
- Exit or disposal cost obligations
- Deferred revenue
- Commitments
- Contingencies
 - Loss contingencies
 - Gain contingencies
- Guarantees

- Debt
 - Debt with conversion and other options
 - Participating mortgage loans
 - Product financing arrangements
 - Modifications and extinguishments
 - Troubled debt restructurings by debtors
- Distinguishing liabilities from equity
- Equity
 - Stock dividends and stock splits
 - Treasury stock
 - Quasi-reorganizations
 - Equity-based payments to nonemployees
 - Spinoffs and reverse spinoffs
- Revenue recognition
 - Products
 - Services
 - Multiple element arrangement
 - Milestone method
 - Rights to use
 - Construction-type and production-type contracts
 - Gains and losses
 - Principal-agent considerations
 - Customer payments and incentives
- Cost of sales and services
- Compensation
- Compensation—nonretirement postemployment benefits
- Compensation—retirement
 - Defined benefit plans
 - Other postretirement benefit plans
 - Defined contribution plans
 - Multiemployer plans
- Compensation—stock compensation
 - Awards classified as equity
 - Awards classified as liabilities
 - Employee stock ownership plans
 - Employee share purchase plans
- Other expenses
 - Start-up costs
 - Insurance costs
 - Contributions made
 - Real and personal property taxes
 - Advertising costs
 - Electronic equipment waste obligations
 - Business and technology reengineering

- Research and development
 - Research and development arrangements
- Income taxes
 - Intraperiod tax allocation
 - Other considerations or special areas

Broad Transactional Categories

- Business combinations
 - Identifiable assets and liabilities, and any noncontrolling interest
 - Goodwill or gain from bargain purchase, including consideration transferred
 - Reverse acquisitions
 - Related issues
- Collaborative arrangements
- Consolidation
 - Control of partnerships and similar entities
 - Research and development arrangements
- Derivatives and hedging
 - Embedded derivatives
 - Hedging
 - Fair value hedges
 - Cash flow hedges
 - Net investment hedges
 - Contracts in entity's own equity
 - Weather derivatives
- Fair value measurements
 - Registration payment arrangements
- Foreign currency matters
 - Translation of transactions
 - Translation of financial statements
- Interest
 - Capitalization of interest
 - Imputation of interest
- Leases
 - Operating leases
 - Capital leases
 - Sale-leaseback transactions
- Nonmonetary transactions
- Related-party disclosures
- Reorganizations
 - Quasi-reorganizations
- Subsequent events

- Transfers and servicing
 - Sales of financial assets
 - Secured borrowings and collateral
 - Transfers to qualifying special-purpose entities
 - Servicing assets and liabilities

Industry/Unique Topics

- Agriculture
- Airlines
- Contractors—construction
 - Contract costs
- Contractors—federal government
 - Contract costs
- Development stage entities
- Entertainment—broadcasters
- Entertainment—cable television
- Entertainment—casinos
- Entertainment—films
 - Other assets—film costs
- Entertainment—music
- Extractive activities—mining
- Extractive activities—oil and gas
- Financial services—brokers and dealers
 - Broker and dealer activities
- Financial services—depository and lending
- Financial services—insurance
 - Insurance activities
 - Acquisition costs
 - Claim costs and liabilities for future policy benefits
 - Policyholder dividends
 - Premium deficiency and loss recognition
 - Separate accounts
- Financial services—investment companies
 - Investment company activities
- Financial services—mortgage banking
- Financial services—title plant
- Franchisors
- Health care entities
- Not-for-profit entities
 - Financially interrelated entities
 - Split-interest arrangements
- Plan accounting—defined benefit pension plans
 - Accumulated plan benefits

- Net assets available for plan benefits
- Terminating plans
- Plan accounting—defined contribution pension plans
 - Terminating plans
- Plan accounting—health and welfare benefit plans
 - Net assets available for plan benefits
 - Plan benefits obligations
 - Terminating plans
- Real estate
- Real estate—common interest realty associations
- Real estate—real estate investment trusts
- Real estate—retail land
- Real estate—time sharing activities
- Regulated operations
 - Discontinuation of rate-regulated accounting
- Software
 - Costs of software to be sold, leased, or marketed
- U.S. steamship entities

These topics do not tell analysts everything they want to know about a company, but for most companies, the GAAP-required disclosures provide a road map that not only tells analysts what is important to understanding a company and the securities it issues but also—and perhaps more importantly—gives them clues about important things they do not know. Admittedly, there probably will not be GAAP-related disclosures, at least early on, that a new product being developed by a competitor might negatively affect an issuer, as for example, when Microsoft's Internet Explorer won market share from Netscape. Nonetheless, the tendency toward making negative disclosures under GAAP is a strong one. Since the 1970s independent auditors have been devastated by damage awards in securities lawsuits claiming accountants' liability. It can be taken for granted that large accounting firms are going to press managements, which are responsible for preparing the financial statements reviewed by auditors, to make any negative disclosures that are admissions against interest. Independent auditors of the statements of companies with publicly traded securities are usually very careful in comporting with not only GAAP rules, which cover what is to be disclosed in financial statements, but also Generally Accepted Auditing Standards (GAAS), which cover the procedures to be followed in preparing an audit. The climate fostered by developments in accountants' liability may not be overly productive for society as a whole. Nonetheless, the environment created is something that prudent value investors recognize and take advantage of.

How is the GAAP road map used by fundamental finance analysts in most of their analyses?

- **As a disciplined setting in which to understand the operations and the investment potentials of the business.**
- **As a huge aid in flagging contingencies, risks, and uncertainties of all sorts.**
- **As a good tool for appraising managements.** For example, when managements have accounting choices (e.g., accounting for oil and gas exploration by using either full cost accounting or successful efforts accounting), analysts will look at the choices made by management to gauge whether management is basically conservative or promotional. A super-strong balance sheet may be evidence that a management is

extremely conservative.

- **As a good tool for ascertaining which documents are material and ought to be reviewed:** long-term loan agreements, leases, pension plans, labor contracts. These will, to a greater or lesser extent, be described in financial statement footnotes.
- **As a good tool for looking at the quality of a company and its survivability as gauged by the auditors' opinion.** A clean certification is at least a small source of comfort; a qualification in the certificate about a company's ability to survive as a going concern should be a source of caution for holders of parent-company common stock and perhaps for other holders of junior securities—say, subordinated debentures.

For many types of analyses, GAAP are not all that helpful, although it is always an essential tool.

When the quality of a corporation's resources is measured in part by the presence or absence of liabilities either on the balance sheet or in footnotes, GAAP are crucial.

When a business's success is measured by new discoveries (e.g., oil wildcatting) or new inventions (e.g., an advanced computer chip not yet marketed), GAAP disclosures are far from central to an analysis from the point of view of an OPMI stockholder.

Generally accepted accounting principles have a number of basic shortcomings:

- Most GAAP are directed toward the interests of parent-company shareholders. For such constituents, consolidated financial statements are most meaningful. For creditors, there is often a need for consolidating—rather than consolidated—financial statements so that the creditors can assess how cash might flow from operating subsidiaries to parents as well as examine the balance sheets of material corporate entities.
- GAAP based on accrual accounting frequently run into difficulties explaining corporate cash experiences. Cash accounting, by the way, has considerable problems in failing to disclose corporate wealth creation and operating results, as measured by accrual principles.
- GAAP are often not helpful when businesses create wealth through having unrealized—and therefore unreported—appreciation of assets for which there are no readily ascertainable market values. Companies with large holdings of undeveloped acreage are examples of these types of businesses.
- GAAP are probably not very helpful for investors focused strictly on forecasting future growth trends in income or cash flow without looking to the leavening provided by non-income account GAAP disclosures.
- GAAP are something of a vaccine against securities frauds. It seems logical that most people engaged in unscrupulous stock promotions or outright frauds would choose to promote as investment vehicles those entities where the false sizzle is a story unrelated to GAAP. Tax shelters, penny stocks, emerging market equities, trading systems, commodity plays, new discoveries, and new inventions are the raw materials used by most unscrupulous promoters. The factor these investment vehicles have in common is that GAAP do not weigh heavily as part of the investment story.

The road-map aspects of GAAP are crucial to making investing decisions. Audited statements,

including footnotes and the accountant's opinion letter, constitute comprehensive disclosures within a disciplined setting. Those responsible for preparing the statements have strong financial incentives to have those statements flag certain business problems—say, potential environmental liabilities.

In fundamental finance investing by OPMIs, there is frequently a primacy of the *quality* of resources in a company. A major factor in gauging the *quality* of resources is the presence or absence of liabilities, whether on the balance sheet, in the footnotes, or undisclosed altogether. Auditors will make great efforts to flag and describe these liabilities:

- Long-term debt
- Environmental contingencies
- Litigation contingencies
- Pension plans and other long-term employee obligations
- Material leases

Footnote topics include the basis of consolidation, fixed assets, inventories, income taxes, pension and other postemployment benefit plans, debt, lawsuits and other loss contingencies, marketable securities and other investments, significant customers, sales to related parties, and export sales.

Under GAAP, a corporation is required to accrue a loss on balance sheet when (1) it is probable that an impairment has occurred and (2) the amount of the loss can be reasonably estimated. Moreover, footnote disclosure is required when a loss is reasonably possible. Having these loss disclosures is usually quite important.

Risks and uncertainties are also part of a GAAP audit. Under GAAP, a company is required to disclose the following:

- The firm's major business activities and markets.
- The firm's use of estimates.
- Certain significant estimates.
 - Pension expense and related liabilities are significantly impacted by two key estimates: (1) the expected future rate of return on plan assets, and (2) the discount rate used to discount the future pension liability. An example of an extremely aggressive use of estimates would be a firm that has 75 percent of their pension assets in fixed-income but uses a 9 percent discount rate to estimate their pension benefit obligation liability.
 - Loss reserves. Significant estimates from management are utilized in calculating future probable losses and booking the related reserve.
- The firm's current vulnerabilities due to certain concentrations.

Supplementary schedules are another tool providing important disclosures for investing purposes:

- Estimates of the value of proved oil and gas reserves discounted to present value at a 10 percent discount rate (known as SEC PV 10).
- Schedule V of annual reports to the SEC giving data about developed real estate.
- Impact of changing prices.
- Disclosure of sales revenue, operating income, and assets employed for major business segments, by geographic areas; data about export sales.
- Disclosures related to financial instruments and hedging activities.

Management discussion and analysis of quarterly results and of financial position, liquidity, and capital resources are required to include a breakdown of significant effects of known trends,

events, and uncertainties (e.g., decline in market share). There is also to be a discussion of discontinued operations and other nonrecurring items.

Although GAAP are always an essential tool, the importance of that tool in the information mix depends on what is analyzed. GAAP are probably almost always key in credit analysis; they are also always key in the equity analysis of most strict going concerns; they are sometimes not helpful in analysis of tax shelter (TS) investments; and they are least useful in appraising companies whose value depends on new inventions and discoveries.

SUMMARY

The purposes and uses of accounting in fundamental finance seem quite different from those in conventional approaches. We view financial accounting as a tool to help analysts approximate (1) the performance of a business during a particular period and (2) the quality and quantity of resources existing in a company at any one moment. Over and above these factors, financial accounting is also a tool used to make judgments about many nonfinancial (i.e., non-numeric) factors including the appraisals of management and finding information about material documents such as leases, loan agreements, pension plans, and so on. Because GAAP imposes relatively rigid sets of rules and are overseen and reviewed by independent professionals who render opinions (public accountants), audited financial statements are often the only numeric reports available to security analysts that give them reliable, objective information prepared in a disciplined setting. GAAP are not truth or reality, but a tool analysts use to determine their own versions of truth. By contrast with GAAP, other numeric reports (e.g., investment bankers' opinions and appraisers' reports) often lack objectivity and independence. There are special circumstances when the reported accounting numbers define economic reality, legal reality, or both as when GAAP numbers are used in the testing of loan covenants, or in regulatory tests of capital adequacy for regulated financial institutions. Audited financials, interim financials, and the management discussion and analysis (MDA), available either in company internet postings or SEC filings, provide a comprehensive disclosure framework that enables a fundamental finance analyst to understand much about most—but far from all—businesses and the securities, both credit and equity that they issue.

* This chapter contains original material and parts of the chapter are based on material contained in Chapter 9 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman), Chapter 8 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (© 2006 by Martin J. Whitman and Martin Shubik), and ideas contained in the 1999 3Q, 2001 3Q, 2002 1Q, 2002 2Q, 2009 3Q, and 2004 3Q letters to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ In no small part this is a reflection of the pervasive influence of ideas originating in academic finance where businesses are viewed as pure going concerns. For a more detailed discussion of this topic we refer the reader to Chapters 2 and 17.

² Under IFRS independent appraisals of income-producing real estate properties are required. Insofar as the appraisal relies on the income approach to valuation (as all appraisals do) the valuation will also give reasonable estimates of what future cash flows are likely to be with the principal uncertainty usually revolving around predicting future capitalization rates rather than future flows.

³ We discuss the pitfalls of this approach to forecasting earnings in Chapter 6 on net asset value.

⁴ The distinctions between the pure going concern and resource conversion attributes of a business are discussed in Chapter 2.

⁵ The issue of equilibrium pricing is discussed in Chapter 17.

⁶ See an example of how a fundamental finance investor defines *net current assets* very differently from how it is presented on the classified GAAP balance sheet in the section in

Chapter 6 titled “Net Nets Redefined.”

⁷ We thoroughly discuss the issue of employee stock option accounting in Chapter 3 on substantive consolidation.

⁸ We cover the appraisal of managements in Chapter 11.

⁹ The analysis of the private equity LBO of Hertz Global Holdings is discussed in Chapter 25.

CHAPTER 20

Company Disclosures and Information: Following the Paper Trail in the United States*

[Narrative Disclosures in the United States](#)

[The Documents and How to Read Them](#)

[What the Paper Trail Does for the Outside Investor](#)

[What the Paper Trail Doesn't Do](#)

[How Good Is the Paper Trail?](#)

[Summary](#)

Narrative disclosures are used in fundamental finance as tools for gaining understanding of a business—its operations, values, problems, potentials, and long-term management direction. Except for occasional forays into risk arbitrage, the investor following a fundamental finance approach does not attempt to predict near-term prices for securities traded in outside passive minority investor (OPMI) markets.

The principal purpose for using narrative disclosures in much of Graham and Dodd, in modern capital theory (MCT), in broker-dealer research departments, and among conventional money managers is as a tool aiding analysts in predicting market prices for common stocks trading in OPMI markets in the period just ahead. Certain of these market participants use narrative disclosures as an aid in understanding a business. The primary objective of these market participants, however, remains to predict OPMI market prices over the near term rather than to understand a business.

Given these differences in purposes, it is not surprising that corporate disclosures are used quite differently in fundamental finance from how they are used elsewhere. In fundamental finance no one type of disclosure is of overriding importance. The entire mix of information counts. The information that is most important varies on a case-by-case basis, so timeliness of disclosures is not a matter of material consequence, although it always is for other disciplines, relative completeness of disclosures is always a matter of material consequence.

NARRATIVE DISCLOSURES IN THE UNITED STATES

In the United States, as nowhere else in the world, written disclosures are comprehensive and reliable. As a matter of fact, the very comprehensiveness and reliability of these disclosures make

them essential working tools for all types of creditors and investors, from commercial-bank lending officers to individual common stock investors. The key disclosure documents for creditors of, and investors in, public companies are those issued pursuant to rules and regulations promulgated by the Securities and Exchange Commission.¹

These frequently crucial documents disclose information in two forms—financial statements and narratives. Our primary interest in this chapter is in narrative disclosures. As far as mailings and website postings to securities holders and filings with the Securities and Exchange Commission (SEC) are concerned, there are three general types of disclosures that are highly important for investors following a fundamental finance approach.

Freewheeling Disclosures from Which Management Opinions and Management Styles Become Evident

These documents include:

1. The letter from the chief executive officer (CEO) in the annual report to stockholders (ARS)
2. Product and activity descriptions in the ARS
3. Press releases
4. Conference calls with the investment community
5. Addresses to security analysts' societies
6. Narratives in quarterly reports
7. Management Discussion and Analysis of Financial Condition and Results of Operations (MDA) contained in all filings of Forms 10-K and 10-Q

The limits on what can be stated on a freewheeling basis by a management whose comments are reviewed by securities' counsel, as most of them are, loosely follow the strictures on free speech that are imposed by Regulation 10b-5 of the amended Securities Exchange Act of 1934. The scope of permissible insider disclosures has been expanded by the Safe Harbor Act (under the Private Securities Litigation Reform Act of 1995) so that now, subject to hedge clauses, managements are freer to make forecasts. Regulation 10b-5, however, remains a dominant consideration. The relevant portion of 10b-5 states,

It shall be unlawful for any person . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.

Often, CEO letters in ARSs and quarterly reports allow management to take credit for what goes right while blaming uncontrollable circumstances for what goes wrong.

Stereotypical Filings with the SEC

Principal documents of the paper trail include:²

- *Form 10-K* is the official annual business and financial report that must be filed by most companies with the SEC.
- *Form 10-Q* is the quarterly financial report filed by most companies with the SEC that includes disclosure of certain material and extraordinary events that occurred during the reported three-month period.

- *Form 8-K* is a report to the SEC, within four business days of the occurrence of a reportable event, of unscheduled material events or corporate changes, for example:
 - Amendments to articles of incorporation or bylaws; change in fiscal year
 - costs associated with exit or disposal activities
 - Creation of a direct financial obligation or an obligation under an off-balance-sheet arrangement of a registrant
 - Departure of directors or officers; election of directors; appointment of officers
 - Entry into a material definitive agreement
 - Fair disclosure—regulation FD
 - Financial statements and exhibits
 - Results of operations and financial condition
 - Submission of matters to a vote of security holders
 - Other events
- *Annual reports to stockholders* are the most important way most public corporations communicate directly with stockholders.
- *Quarterly reports to stockholders* are statements many companies provide every three months directly to their stockholders.
- *Annual meeting proxy statements* are documents mailed to stockholders soliciting their votes for election of directors and other matters, such as the appointment of independent auditors. If a company does not solicit proxies, information that would otherwise have been disclosed in proxy statements is disclosed in Part II of Form 10-K.
- *Merger proxy statements* are issued when stockholders are to vote on a resource conversion matter—for example, merger, consolidation, and sale of assets or liquidation. If new securities are to be issued as part of the resource conversion event, the merger proxy statement also serves as a prospectus for the new issue of securities, and is registered as an S-4 Registration.
- *Prospectuses* are part of registration statements and are issued when securities are to be offered publicly, either for cash or in an exchange-of-securities transaction where no stockholder vote is sought. Principal registration forms are the S-1 (a generalized form) and the S-7, a short form used by seasoned companies with relatively healthy operating histories. Preliminary prospectuses are known as red herrings.
- *Cash tender offer circulars* are sent, or otherwise made available, to stockholders when a publicly announced offer is made to buy shares for cash from the general list of stockholders.

These disclosures are prepared by attorneys who often follow slavishly the forms embodied in SEC Regulations S-K. A common mind-set in preparing these disclosures is that the quantity and quality of disclosures should be such that lawsuits are avoided.

The use of SEC disclosures is the key to our fundamental finance approach. Indeed, there seems to be an almost symbiotic relationship between SEC-prescribed disclosures and our approach in that the SEC seems to make special efforts to provide the types of information that are most important to us.

The presence or absence of encumbrances is almost always spelled out in SEC documents to

those who carefully read financial statements (including footnotes), especially audited financial statements. SEC disclosures also permit insights into management character at least insofar as their relationships with security holders are concerned. Information about these matters is contained either in proxy statements for annual meetings, or when proxies are not solicited, in Part II of Form 10-K, the company's annual report filed with the SEC. The proxy statement and Part II of the 10-K contain descriptions of management remuneration, certain transactions with insiders, and in proxy statements where shareholder votes are solicited, proposals designed to insulate management in office. Also, financial statements, Form 10-K and Part II of Form 10-Q (the quarterly report filed with the SEC) contain disclosures on litigation. All these items give evidence to analysts about management attitudes and management character.

Neither academics, whether economists or finance professors, nor securities traders seem to appreciate just how useful these documents are. This failure can perhaps be explained by the fact that most of the critics have had virtually no experience in preparing the documents required by the SEC. Document preparation has been left largely to investment bankers, practicing lawyers, accountants, and members of corporate managements. Although firsthand experience as a document preparer is not essential to understanding the uses and limitations of the paper trail, an investor (or critic) ought to comprehend how the preparers go about composing the materials that they must file with the SEC or mail to securities holders.

The first thing to remember is that there are few liars among document preparers. Virtually no professional accountant, lawyer, investment banker, or, especially, independent auditor wants even to be suspected of misleading investors, much less of fraud. The professionals whom we know and work with do not wish to risk their livelihoods and reputations for the benefit of third parties, such as managements and large stockholders.³ As a general rule, the information gleaned from the paper trail is truthful and reliable in stating whatever it purports to state.

This is not to say that all these documents are complete and accurate. There is shortcutting, but much of it is inadvertent. It is sometimes difficult for competent and honest document preparers to make appropriate judgments as to what are material disclosures. However, in our experience, important nondisclosures do not occur frequently. Some shortcutting is undoubtedly deliberate, but the outright frauds or possible frauds—Equity Funding, Stirling Homex, National Student Marketing, Westec, Enron, and WorldCom—seem few and far between.

Second, as we have already pointed out, in preparing documents, there are two well-established rules:

1. Follow the required form so that specific regulations are complied with.
2. *Don't* run afoul of antifraud provisions of the securities laws.

These antifraud provisions make it unlawful in connection with the purchase or sale of any security for any person, directly or indirectly, "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."⁴ The typical preparer of documents, therefore, is going to try to disclose, as truthfully as possible, everything he thinks is factually relevant. He will do this to avoid trouble, both from government regulators and from private securities holders whose attorneys may bring class-action suits, either derivatively or directly, to redress their grievances.

Understanding this is a large part of understanding why the paper trail is so useful. In most commercial and economic transactions, any sensible participant has to worry about the truthfulness of the other parties to the transactions. This is rarely a consideration for followers of the paper trail, who rely on written disclosures. It is as if the person contemplating the purchase of a used car could know that the salesman who says "This auto was only driven on Sundays by a little old lady going to church" is telling the truth. Being able to rely on the truthfulness of disclosures about publicly held corporations is of enormous help to any creditor or investor in coming to financial judgments.

Sources of Readily Available and Useful Disclosures in

Addition to Freewheeling Disclosures, SEC Filings, and Security Holders' Mailings or Website Postings

These sources include the following:

1. Court records, in connection with both litigation and Chapter 11 reorganization proceedings
2. Filings with other regulatory agencies
3. Competitor SEC filings and stockholder mailings
4. Trade association reports
5. *The Wall Street Journal*
6. Other financial newspapers and magazines
7. Online summary services such as Bloomberg, Capital IQ, FactSet, Reuters, etc.
8. *Bankruptcy Reporter*, *Daily Bankruptcy Review*
9. Industry publications such as *Ward's Automotive Reports*, *Women's Wear Daily*, *Clarksons Shipping Intelligence Network*, etc.

THE DOCUMENTS AND HOW TO READ THEM

In order to take full advantage of disclosure, the reader ought to have an understanding of what is contained in principal disclosure documents. The first and most important thing to do is to read them. Almost anyone, after carefully reading, say, five 10-Ks and four merger proxy statements, will have good insight into how their contents can help him in an investment program.

Second, the reader should obtain copies of the forms and the general regulations for the preparation of forms. Reading such materials will give good insight into what preparers go through to produce the various key documents. Investors pursuing an in-depth study of these forms can obtain copies of them as well as general instructions and guides for their preparation from the SEC website.⁵

There are other SEC filings that are occasionally important, but these are beyond the scope of this brief chapter. These include offering circulars under Regulation A and filings by insiders concerning their shareholdings and changes in holdings (Forms 3 and 4); and Form 144, filed by holders desiring to sell restricted stock under Rule 144. Form 13F, filed quarterly by institutional investment managers exercising discretion over accounts holding more than \$100,000,000 of marketable equity securities, describes the securities held in those portfolios.⁶ Notices of various filings can be found in the *SEC News Digest*, a daily summary of SEC activities,⁷ including rules and related matters, announcements, registrations, and filings in connection with tender offers and 5 percent ownership; the *SEC Docket*, a weekly compilation of the full text of SEC releases; and the *Official Summary*, a monthly summary of securities transactions and holdings reported by insiders, taken from Forms 3 and 4 as filed.

Most documents—for example, annual reports, annual meeting proxy statements, prospectuses, and cash tender offers—are publicly distributed. The investor who wants to study any of these can easily find them and download them for free from the Company's website or from the SEC website: www.sec.gov.

WHAT THE PAPER TRAIL DOES FOR THE OUTSIDE INVESTOR

Once all this information has been gathered, how useful is it? How limited? Though it is not particularly useful for the trader who seeks immediate market performance, we think it is extremely useful for all other investors, whether they be control buyers, distress investors, or passivists, who have a modicum of training in what to look for. The paper trail is especially useful in allowing those using the fundamental finance approach to arrive at very meaningful judgments most of the time.

This does not mean that the paper trail is perfect. Certainly it will not tell the creditor or investor everything he wants to know. Even so, unless the outsider has some special know-how or know-who, we think it is so good that he would do well to restrict his investments to securities covered by the paper trail. In fact, when we advise European clients about U.S. investments, we frequently recommend securities to them, rather than, say, real estate, precisely because the paper trail exists, and the disclosures it provides mean that other things being equal, an investment will involve a lesser element of disclosure risk than one in any non-SEC filing enterprise.

For the followers of the fundamental finance approach, the paper trail is excellent, as we noted above, for pointing to junior tranche securities that because of poor financial position or insider avarice are unattractive at any price. But it is also highly useful in a more positive sense: An investor can obtain quite reliable assurances that a company's financial position is strong and that insiders are not overreaching, or based on past performance, are likely to overreach in the future.

In effect, much of the entire SEC narrative disclosure process and many of the disclosures of financial accounting are directed toward informing investors about corporate obligations. Stockholder annual reports, 10-Ks, 10-Qs, 8-Ks, and where issued, other documents will give investors strong clues to the encumbrances attached to a business entity. Particularly important in this regard are audited financial statements, including the auditor's certification and the footnotes to the financials. Descriptions of on-balance-sheet debt and footnote descriptions of encumbrances, including balance sheet items, pension plan obligations, and contingent liabilities, tend to be carefully and accurately done.⁸ Indeed, it appears to us that the footnotes to audited financial statements provide an excellent road map to analysts seeking to undertake a "due diligence" investigation, where the analyst seeks both public and nonpublic information.

Auditors' certificates are particularly important as attestations that have become increasingly carefully worded in recent years. Such attestations are either *clean*—presented without qualification—or *subject* to certain conditions. Additionally, there are what in effect are nonattestations, namely adverse opinions or disclaimers of opinions. Clean opinions, as distinct from certain but not all subject-to opinions, adverse opinions or disclaimers of opinions, are important in giving comfort to investors following the fundamental finance approach; such investors are unlikely to be interested in a junior security on the basis of an opinion subject to a serious qualification (such as "subject to the ability to continue as a going concern"), or on the basis of an adverse opinion or of a disclaimer of opinion.

The encumbrances that are missed by the paper trail tend to be those that sometimes even the insiders are unaware of. One example is a business that enjoys a strong financial position only because it fails to make needed expenditures to modernize, expand, or replace outdated facilities. In such cases, a strong financial position is deceptive, and the strong balance sheet will tend to be dissipated in future years as the business suffers large operating losses, embarks on massive catch-up capital expenditure programs, or both. (This is precisely what happened in the cement industry in the late 1950s and early 1960s.) Nonetheless, it has been our experience that most of the time, the paper trail does disclose enough, so that the investor's estimate of what the total encumbrances will prove to be are relatively accurate.

The paper trail is also fairly good in giving clues about insider overreaching. Proxy statements for annual meetings at which directors are elected contain disclosures about management remuneration,⁹ about borrowings by insiders from the company, and about certain transactions—dealings and participations between the company and its insiders. In addition, the long-term record of management is revealed, and this is helpful to analysts who tend to believe that behavior

patterns probably do not change much, if at all.

EXAMPLE

Since the management of Rapid American Corporation forced out minority shareholders of Schenley Industries in 1971 at what we believed, from examining the 1971 proxy material, was a grossly unfair price, we concluded that we would rather not be an outside investor or creditor in any company controlled by the Rapid American management, albeit there was nothing illegal about the Schenley Industries force-out.

True, much past insider overreaching may escape disclosure in the documents of the paper trail. Certainly the documents as they exist today leave few clues concerning such matters as the prevalence of widespread nepotism at levels below parent-company officers and directors. Yet, there appear to be sufficient data, so that the outside investor can make reasonable judgments about the character of the insiders, at least insofar as it affects actual or proposed investments.

An investor may decide that a security meeting the criteria of a fundamental finance approach is attractive because of additional considerations. The paper trail will help him uncover these other attractions, perhaps providing hints that future earnings might increase dramatically; that large cash distributions to stockholders are likely; that a company is a takeover candidate; that it is likely to be liquidated or recapitalized in whole or in part; or that a security is priced inexpensively compared with other companies, based on its history.

The paper trail can provide information that is crucial to assessing each of these factors. The knowledge gained from it about a company's business and operations provides a reasonable basis for making judgments about future earnings, cash returns, and risk. Information about who owns the company's stock, who is acquiring it and what resources the company has may tell whether or not it is a likely candidate for a takeover, or for a liquidation or recapitalization.

As we stated before, the paper trail enables an investor using the fundamental finance approach to pinpoint those securities that are unattractive at any price. The statement that everything has a price at which it is a bargain is, as a practical matter, simply not true when it comes to investment. Junior securities—especially those that are pure residuals, such as common stocks and warrants—may be in such a hopeless position that they are likely never to have a value high enough to compensate for the costs of ownership. This may happen in one of two situations. The first is where the financial position of the company is so bad that whether the company is in bankruptcy or not, the entire business has to belong to the creditors.

The second situation in which equity securities should be avoided at any price is that of a going concern with an entrenched management whose prime objective is to milk the company for personal benefits at the expense of the security holders. By far the best way to pinpoint such a situation is to follow the paper trail.

WHAT THE PAPER TRAIL DOESN'T DO

The principal shortcoming of the paper trail stems from the fact that it is designed and used to provide material disclosures of hard information. Soft information, such as company forecasts,

company budgets, and valuation appraisals of assets—for example, appraisals of the value of income producing real estate—are not disclosed.¹⁰ This is principally because much soft information is a tool for stock market manipulation.

The SEC, however, has expanded the promulgation of soft information through new rules and regulations. A breakthrough in requiring soft information probably occurred in 1976 when the SEC, for the first time, required companies with inventories and gross property, plant, and equipment aggregating more than \$100 million and comprising more than 10 percent of total assets to provide supplementary data in the 10-K about estimated replacement costs (Accounting Series Release 190, dated March 23, 1976). In 1978, the SEC proposed guides that permitted and encouraged projections of financial information by companies. These forecasts were to be made voluntarily, and forecasters were to be given a safe harbor, that is, they generally would not be held liable under the federal securities laws for reasonably based projections that did not work out (Exchange Act Releases 15305 and 15306, dated November 7, 1978). Also, in Accounting Series Release 253, dated August 31, 1978, the SEC adopted requirements for supplemental disclosures for fiscal years ending after December 25, 1979, of the valuation (and changes in valuation during the year) of certain companies' proved oil and gas reserves; this is a method of accounting the SEC calls reserve recognition accounting, or RRA.

Sometimes this soft information may be vital to understanding a business, either as a resource conversion enterprise or as a going concern.

EXAMPLE

In early 1976 Tishman Realty announced liquidation plans. Without knowing the prices at which Tishman's real properties could be sold, there was no realistic basis for judging the merits of Tishman as an investment; and without real estate appraisals of the individual properties, it was extremely difficult to approximate these prices.

EXAMPLE

Another example is Duplan Corporation, which in early 1976 found itself in serious financial trouble, its very viability threatened unless it could become profitable in six months to a year. Here, management forecasts and budgets were crucial to anyone contemplating becoming an investor in or creditor of Duplan.

There are many other kinds of information besides management forecasts, budgets, and asset appraisals that the paper trail fails to disclose. For example, there are no disclosures of merger and acquisition discussions that never reach a definitive state. There rarely will be information about comparative cost analysis, comparative security prices or comparative market penetrations within an industry. Ordinarily, outsiders do not know what a company ought to spend on plant equipment or inventory in order to remain competitive. The paper trail rarely includes disclosures

of detailed special studies in areas such as marketing or engineering. Nor will there be information about long-festering internal disputes among management. Occasionally, even obviously material hard information may be lacking.

EXAMPLE

Companies may provide only consolidated financial statements in situations where such statements would be less informative than consolidating or company-only statements. (In consolidating or company-only statements, information about the parent company and individual subsidiaries is disclosed, whereas such information is not shown separately in consolidated statements.)

There may even be situations that the paper trail misses entirely.

EXAMPLE

An example would be a very small acquisition that does not require a stockholder vote. If such a vote were required, proxy statements would be mailed to shareholders. Without a proxy or 8-K filing, the financial statements and descriptions of the companies being acquired would not be available at all from SEC filings.

It is important to note, of course, that the lack of soft information on the paper trail is a much less serious shortcoming for the long-term investor than it is for the trader. For the trader, a near-term earnings forecast or dividend action may be the only disclosure of interest. The long-term investor, especially the investor whose analysis rests on the fundamental finance approach, is resource conscious; the hard information disclosed by the paper trail is of great importance to him in virtually all his evaluations. Furthermore, for this investor an apparent low price relative to an estimate of the resources in the business can compensate for the risks inherent in knowing less about a company than would be optimal. This safety valve does not exist for the trader who is seeking the best possible near-term market performance.

HOW GOOD IS THE PAPER TRAIL?

The SEC paper trail provides the investor with a stereotyped format. The disadvantage of the stereotyped format, of course, is that following a form frequently results in inadequate descriptions of reality and inadequate weighting of what is important. The principal advantage is that the reader can be assured that the professional preparers are striving to see that the documents do not

omit material statements and do not contain material mis-statements. In addition, the investor who uses stereotyped documents becomes a very practiced reader and can obtain vast quantities of information merely by skimming, because he knows what to look for and where to look for it.

On balance, our appraisal is that most of the time the paper trail is excellent. We have reached this conclusion in large part on the basis of our experience in conducting in-depth analyses for companies that retain us. In these situations, the companies provide all the data we want and do studies to generate any necessary data that is otherwise unavailable. Invariably, these in-depth analyses have been materially easier to do and more meaningful for users when we have had SEC documents available as a source of information and as a check against other information received. We are sure this holds true also for virtually all other analysts doing comparable studies. This points up, incidentally, one of the more important social and economic benefits to the United States from the paper trail: It has uplifted the standards of analysis, making it infinitely easier to conduct meaningful analyses for all sorts of appraisers, from commercial-bank lenders to government officials, who may not be interested in securities markets *per se* or common stock investing at all.

Of course, the paper trail is always going to be more useful for some kinds of companies than for others. For example, for large, stable, dividend-paying companies, such as Graham and Dodd's theoretical list of the one hundred highest-quality issuers, the paper trail probably imparts more information to outside investors than they care to know. On the other hand, in areas where GAAP are not an overly useful tool—such as in the analysis of extractive industries, real estate development companies, and emerging issuers—the nonaccounting disclosures of the paper trail are not going to be too useful either. For the whole range of companies in between, however, the paper trail is a godsend.

Anyone who follows the paper trail must, of course, appreciate what it cannot do for him. First and foremost, much of the world is unknown and unpredictable. Thus, forecasting will always be an art. Second, the paper trail is probably not of much help in gaining insight into immediate timing and immediate performance in the stock market. Obviously, there is no way the paper trail is going to disclose intimate secrets of activists and their plans, which are frequently formulated no place else but in their minds. Nor does it provide anyone with know-who, even though it does tend to give the background that makes it easier to obtain.

The paper trail does *not* provide full disclosure, and never can. Like any other analytical tool, it has its limitations. But for the investor who concentrates on our approach, the paper trail is going to be the essential starting point for his analysis almost all of the time. In some instances, the paper trail is all he or she will ever need.

SUMMARY

Narrative disclosures are used in fundamental finance as tools for gaining understanding of a business—its operations, values, problems, potentials, and long-term management direction. In the United States, as nowhere else in the world, written disclosures are comprehensive and reliable. The key disclosure documents for creditors of, and investors in, public companies are those issued pursuant to rules and regulations promulgated by the Securities and Exchange Commission (SEC). There are three broad types of disclosures used in due diligence investigations: (1) freewheeling disclosures from which management opinions and management styles become evident; (2) stereotypical filings with the SEC; and (3) other sources of information. We provide a detailed description of the three categories. For the followers of the fundamental finance approach, the paper trail is excellent. In effect, much of the entire SEC narrative disclosure process and many of the disclosures of financial accounting are directed toward informing investors about corporate obligations. The principal shortcoming of the paper trail stems from the fact that it is designed and used to provide material disclosures of hard information, which turns out to not be very useful in analyzing the entities engaged in exploration, discovery, and new inventions. On balance, our appraisal is that most of the time the paper trail is excellent.

* This chapter contains original material and parts of the chapter are based on material contained in Chapter 10 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman), Chapter 6 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (© 2006 by Martin J. Whitman and Martin Shubik), and ideas contained in the 2006 4Q letter to shareholders. This material is reproduced with permission of John Wiley & Sons, Inc.

¹ Although SEC disclosures are crucial for most analyses of public companies, they are far from the only disclosure documents that may be important in a given situation. The others, however, are beyond the scope of a book. Chapters 32, 33 and 34 of Volume II of the *Financial Analyst's Handbook*, ed. Sumner N. Levine (Homewood, IL: Dow Jones-Irwin, 1975), 852 are excellent overviews of the types of public non-SEC disclosures that are generally available. Chapter 32, by Dorothy Hennessey Sussman, is entitled "Information Sources—An Overview." Chapter 33, by Sylvia Mechanic, is entitled "Key Reference Sources." Chapter 34, "A Guide to Industry Publications," is a reprint of a brochure originally issued by the New York Society of Security Analysts.

² For a comprehensive description of each of these forms and the instructions on how fill them see <http://www.sec.gov/about/forms/secforms.htm>.

³ We are convinced this remains true despite what we consider to be the Supreme Court's unfortunate language in regard to Section 10b-5 in *Ernst and Ernst v. Hochfelder* 425 U.S. 185 (1976). The vast majority of financial professionals appear to us to be honest and ethical because they want to be, not because they have to be.

⁴ 10b-5 is part of the Securities Exchange Act of 1934 as amended. Prospectus preparers operate under similar and additional strictures growing out of Section 17 of the Securities Act of 1933 as amended. In addition, there are similar strictures existing under other parts of the Securities Exchange Act of 1934 as amended. But 10b-5 is the catchall of the antifraud regulations, covering situations not otherwise enumerated specifically.

⁵ www.sec.gov/about/forms/secforms.htm.

⁶ For a comprehensive list of forms and their descriptions go to: www.sec.gov/about/forms/secforms.htm.

⁷ www.sec.gov/news/digest.shtml.

⁸ Though perhaps not part of any glossary, *on-balance-sheet items* commonly refers to assets or liabilities stated directly on a balance sheet, whereas *off-balance-sheet disclosures* usually refers to information about assets or liabilities disclosed in footnotes to financial statements.

⁹ The management remuneration section of a proxy statement (or Part II of a Form 10-K) will contain information not only about salaries, but also about all other types of remuneration, such as stock options, stock-appreciation rights, pension plan benefits, bonuses, profit-sharing plans, and employment contracts. The SEC also requires that information about management perquisites, such as company hunting lodges or the use of company planes for private purposes, be disclosed.

¹⁰ This is true under GAAP but not under IFRS used by all non-U.S. companies owning income-producing real estate. Such assets under IFRS are carried at appraisal value unlike GAAP where income-producing real estate is carried at depreciated cost less impairments.

CHAPTER 21

Buying Securities in Bulk*

Methods for Acquisition of Common Stocks

Acquisition of Voting Equities through Exchanges of Securities

Acquisition of Control without Acquiring Securities by Using the Proxy Machinery

Summary

An active investor seeking control or elements of control over a publicly traded commercial entity through securities acquisition can follow several different courses of action. From a security holder's point of view, all acquisitions of securities are either voluntary or mandatory. *Voluntary* refers to situations in which each individual security holder can make up his or her own mind as to whether to take certain actions. *Mandatory* refers to voting situations in which all security holders are forced to participate in some action once the requisite number of security holders of that class vote in favor of the action. Each of the methods under which control and quasi-control people acquire securities has advantages and disadvantages. This chapter discusses the advantages and disadvantages of each method in light of the following factors:

- Pricing issues
- Securities law issues
- Income tax issues
- Other regulations
- Availability-of-information issues
- Ability-to-finance issues
- Financial commitment issues
- Doability issues
- Social issues
- Speed
- Rates of return

The methods reviewed below are not mutually exclusive. For example, in seeking control of a company, an activist limited by other regulations (e.g., the need for Hart-Scott-Rodino filings if more than \$15 million is expended on common stock purchase) might still gain a toehold position by acquiring target company common stock for cash in the open market, then follow up by commencing a cash tender offer or by soliciting proxies seeking to elect a new slate of directors. Cash tender offers frequently are preludes to mop-up mergers.

METHODS FOR ACQUISITION OF COMMON STOCKS

There are four methods of acquiring common stock (or other securities) for cash:

1. In the open market
2. In private transactions
3. In tender offers
4. By use of proxy machinery (mergers, reverse splits, consents)

The first three are voluntary; the fourth is mandatory.

Cash Purchases in the Open Market

- **Pricing issues:** Acquisition is possible at outside passive minority investor (OPMI) prices, which tend to be far more irrational and frequently far lower than can be obtained in negotiated transactions.
- **Securities law issues:** No disclosure is required until the 5 percent ownership threshold is reached; no use of inside information is permitted. The Securities and Exchange Commission (SEC), though, is exceedingly tough on anything that smacks of manipulation of OPMI markets. The most important mandate of the SEC, ahead of providing disclosure and oversight of fiduciaries and quasi-fiduciaries, is protecting the integrity of OPMI market places.
- **Income tax issues:** These are not a consideration.
- **Other regulations:** Hart-Scott-Rodino applies when investing over \$15 million.
- **Availability-of-information issues:** These are pretty much restricted to public information.
- **Financial commitment issues:** Buy as little or as much as desired. Margin rules may restrict the ability to borrow.
- **Doability issues:** To gain control, investors probably need to acquire common stock by another—perhaps supplementary—method. (It may sometimes be possible, however, to “Tisch” a company, as in the takeover of control of CBS Corporation by Laurence Tisch solely by purchases of common stock in the OPMI market.) Also, owning cheap stock acquired as a toehold in OPMI market may afford very good returns for having put a company into play even if the acquirer never attains any element of control. On the other hand, if prices rise in an OPMI market, future prices to acquire control by other methods tend to become more expensive than they otherwise would have been.
- **Social issues:** No social issues are involved.
- **Speed:** If the object is to obtain elements of control, the timing involved is likely to be long and indeterminate.
- **Rates of return:** The rates of return are usually plain vanilla.

Cash Purchases in Private Transactions

- **Pricing issues:** Prices reached in negotiated transactions are often far more rational, from a control point of view, than prices in OPMI markets. (From time to time, however, there are anxious or even desperate sellers—for example, the sale of Tejon Ranch common stock by the Times Mirror Company at a 25 percent discount from OPMI market price in 1997.)
- **Securities law issues:** Disclosure issues depend on privacy. Under Section 10(b) of the Securities Exchange Act, Rule 10b-5 is always a factor in terms of implied remedies: when do courts decide that private transactions, market sweeps of OPMI markets, or a combination of the two are mere masquerades for cash tender offers? Also, does the acquirer obtain restricted common or securities freely tradable in OPMI markets?
- **Income tax issues:** Purchases of common stocks for cash are almost always straightforward taxable capital transactions for the sellers.
- **Availability-of-information issues:** Privacy governs; the buyer can seek to know what the seller knows.
- **Ability-to-finance issues:** There is the possibility of seller finance; margin rules may be a factor when there is no change of control.
- **Financial commitment issues:** What issues there are depend on the size of the block being acquired privately. Deal expense may or may not be minimal.
- **Doability issues:** Tying up large blocks tends to make obtaining control easier, whether the source of control is friendly, neutral, or hostile.
- **Social issues:** Sometimes as part of a purchase, there are agreements about board representation and protection of incumbent management.
- **Speed:** Purchase can be pretty fast—days to weeks.
- **Rates of return:** The rates of return are usually plain vanilla.

Cash Tender Offers

- **Pricing issues:** A premium above OPMI market price must be offered. The basic rules are as follows: Immediately after the commencement of a tender offer, the bidder must file a tender offer statement with the SEC and the issuer identifying the bidder and setting forth the source of funds, the bidder's purpose in making the tender (free advertising?), the ownership of other securities of the issuer, and appropriate financial statements for those bidders that are not natural people if the bidders are material to a decision by security holders of the target. The tender offer has to be open at least 20 days—10 days after an increase in price. Nobody of any consequence in the OPMI market tenders until just before a tender offer is to expire. If the tender is for less than all the shares, pro-rata shares must be accepted. The announcement is made promptly and payment is made within 10 days or so after acceptance of shares tendered. If a tender offer is extended, there must be an announcement of the approximate numbers of shares tendered.

- **Securities law issues:** With this method, securities law issues are considerably more onerous than open-market and private purchases but considerably less onerous than using proxy machinery or issuing new securities, which virtually always requires registration under the highly onerous Securities Act of 1933 as amended. Portions of the Securities Exchange Act of 1934, also known as the Williams Act, primarily govern here. In hostile takeovers, state court litigation, especially in Delaware, may take center stage. Even in a friendly takeover, there is likely the need to contend with the plaintiffs' bar representing OPMIs in both federal and state courts. These suits are usually easy to settle, as fee awards primarily drive plaintiffs' counsel.
- **Income tax issues:** These are, as for other purchases, for cash.
- **Availability-of-information issues:** In hostile takeovers, only public information is available; in friendly takeovers, there is a prior opportunity to conduct due-diligence research.
- **Ability-to-finance issues:** Conventional finance may be readily available, starting with secured lenders and working south. Since a bidder can never obtain 100 percent acceptance for a tender offer, however, financing opportunities may be limited unless the bidder announces plans for a mop-up merger that would result in 100 percent ownership of the equity. It tends to be far easier to finance a friendly takeover than a hostile one.
- **Financial commitment issues:** There is almost always a multimillion-dollar commitment to purchase shares. Administrative expenses, including lawyers' fees, printing costs, information agent fees, dealer-manager/investment banker fees, corporate trustee fees, and transfer service fees, are also large.
- **Doability issues:** The key to doability is to offer a price premium above OPMI market price. During the pendency of a cash tender offer, shares are likely to gravitate into the hands of risk arbitrageurs, who toward the conclusion of the tender-offer period will make market decisions (based on the current premiums over OPMI market prices) rather than investment decisions (based on perceptions of fundamental values). In hostile takeovers, there are always uncertainties about doability. There is a huge advantage (or sometimes disadvantage) over soliciting proxies or exchanging securities, in that tender offers are much quicker.
- **Social issues:** If the deal is friendly or the bidder wants to make a hostile or neutral takeover, it is frequently necessary to give terms that reward incumbent managements or other control people with clout.
- **Speed:** Making a cash tender offer is infinitely faster than using proxy machinery or issuing securities. Issuing securities requires registration under the Securities Act of 1933. In using the proxy machinery, there is an additional delay of, say, 20 to 60 days after effectiveness of a proxy statement or a registration statement so that shareholder meetings can be held.
- **Rates of return:** If the cash tender offer is successful, the present value of control becomes important.

Although cash tender offers are classified here as voluntary (each shareholder makes up his or

her own mind whether to tender), a cash tender offer becomes mandatory (i.e., coercive) when the offeror can present a meaningful threat that if enough shares are tendered, the company will deregister with the SEC and there will no longer be a public market for the shares. This can happen when there are fewer than 300 shareholders of record.

Cash Mergers through the Use of Proxy Machinery

- **Pricing issues:** Cash mergers through the proxy machinery almost always offer a premium over OPMI market price, but there is nowhere near the same pressure as in a cash tender, because all that is needed here is the requisite vote of stockholders (e.g., anywhere from 50 percent of those voting to two thirds of outstanding holders once a 50 percent quorum votes) to bind 100 percent of the common stock to the transaction. Outside passive minority investors are a lot more attentive to sale situations at premiums over market than they are to voting situations. The price paid will be reviewed in state court, especially in Delaware, where sometimes there can be a requirement for “entire fairness.” The court will be heavily influenced, however, by OPMI market prices in determining entire fairness. Insiders control timing; they are free to pick depressed OPMI markets as the time for cash mergers.
- **Securities law issues:** It is much more difficult to comply with the provisions of the Securities Exchange Act in soliciting merger proxies than it is in a cash tender offer. The legal liabilities here, however, are far less onerous than when common stocks are acquired for securities rather than for cash. Issuing securities publicly gives rise to strictures existing under the Securities Act of 1933. The SEC clears proxy materials before they are mailed. Lawsuits by the plaintiffs’ bar, both state and federal, are automatic in merger transactions, whether for cash or for securities. (Do insiders in merger transactions sometimes hold back some consideration initially so that they have reserve ammunition to settle stockholder suits?) In force-out mergers, state blue-sky laws, as they exist in California and Wisconsin, for example, can be a problem. In part because of time-consuming delays, it tends to be more difficult to use the cash-merger technique in hostile takeovers than to use a cash-tender offer to be followed by a mop-up merger.
- **Income tax issues:** These are as for other cash deals. After the investor owns 100 percent of target, however, it is easier to do subsequent tax planning on behalf of the surviving companies.
- **Availability-of-information issues:** Control people can do due-diligence research. Disclosure to OPIMs, including making admissions against interest (e.g., providing rosy forecasts), becomes crucially important.
- **Ability-to-finance issues:** Generally, it is more easy to finance here than with any other cash purchase of common stocks.
- **Financial commitment issues:** Usually, these involve megabucks both for the investment and for deal expenses.
- **Doability issues:** Cash mergers are very doable if the investor controls the proxy machinery, but see securities law issues above.

- **Social issues:** It is probably necessary to make a deal with the incumbent management and other control groups with clout.
- **Speed:** Cash mergers are much slower than cash tender offers.
- **Rates of return:** These can be huge, including premiums for control. In the case of the use of proxy machinery for a hostile takeover, the expenditures incurred are probably better analyzed as an investment rather than as an expense. If the investor does fairly well in a hostile proxy solicitation—even if the investor loses—incumbents mostly will pay good-size amounts to get rid of the hostile solicitor. If the hostile solicitor wins, there is no doubt that he, she, or it will be reimbursed for expenditures.

ACQUISITION OF VOTING EQUITIES THROUGH EXCHANGES OF SECURITIES

There are two methods of acquiring voting equities—common and preferred—by way of exchanges of securities:

1. The voluntary method, in which each shareholder makes up his, her, or its own mind about whether to exchange.
2. The mandatory method, in which the proxy machinery is used and in which, except for those who might perfect rights of appraisal, each shareholder has to participate in the proposed exchange provided the requisite vote of shareholders is obtained even those who perfect rights to dissent cease to be shareholders.

Voluntary

- **Pricing issues:** It is necessary to offer a premium over the OPMI market price in terms of the consideration to be received, whether that consideration is cash, debt, preferred stock, common stock of some issuer other than the target, or combinations thereof.
- **Securities law issues:** It is necessary to register under the relatively onerous Securities Act of 1933 (except for a Section 3(a)9 exemption, which involves different securities of the same issuer when no sales compensation is involved). Voluntary exchanges sometimes take a long time to clear the SEC, they are expensive, and their potential liabilities are large. The same problems with state lawsuits and plaintiffs' bar exist as for cash tender offers and cash mergers.
- **Income tax issues:** There are opportunities for tax planning. For example, the exchange of voting securities for voting securities might qualify for a tax-deferred reorganization under Section 368(b) of the Securities Act of 1933, and an exchange of voting common stock for net assets might qualify as a Section 368(c) reorganization.

- **Availability-of-information issues:** The amount of information needed for Securities Act of 1933 registrations sometimes makes voluntary exchanges a difficult tool to use in hostile takeovers. Sometimes voluntary exchanges can be used, however, when the investor is competing against a friendly exchange offer, because then the hostile bidder can clone the friendly bidder's registration papers in describing the target.
- **Ability-to-finance issues:** Exchanging securities means that the initiator is getting target companies' shareholders to finance, at least in part, the bid for control (e.g., the Worldcom bid for MCI in 1997).
- **Financial commitment issues:** Usually, megabucks are involved for both investment and deal expenses.
- **Doability issues:** Voluntary exchanges are okay for friendly takeovers, but they usually are harder than buying for cash.
- **Social issues:** These tend to be huge, especially when the investor wants a friendly takeover and is willing to make a deal with the incumbents.
- **Speed:** Voluntary exchanges are often slow, although the SEC has been speeding up the clearance of registration statements. If clearance is required from other regulators (e.g., the Federal Communications Commission [FCC] or the Federal Trade Commission [FTC]), the process can be long.
- **Rates of return:** These can be off the charts, especially against the background that company A will trade two of its \$60 million of funny money common stocks or junk bonds for \$100 million of company B's solid underlying value, giving OPMIs a 20 percent premium over market.

Mandatory

- **Pricing issues:** These are much like those for cash merger, except that it is harder for the OPMI market to appraise the value of a securities package rather than cash. It is probable that premiums over OPMI market prices offered in exchanges are larger than for cash transactions, other things being equal. This may be especially true in voluntary exchanges.
- **Securities law issues:** These are much like those for cash mergers, except—and this is a big exception—that the issuer has to comply with the Securities Act of 1933 (see the Worldcom S-4 red herring). The S-4 is a combination proxy statement for voting purposes and a prospectus registering securities that are being offered publicly.
- **Income tax issues:** There is more certainty regarding the use of Section 368 under the Internal Revenue Service code to effect a tax-deferred reorganization than is the case for voluntaries. A Section 368(a) reorganization encompasses a merger transaction. Acquirers know they have 100 percent equity ownership at the conclusion of proxy solicitation.
- **Availability-of-information issues:** These are as for a voluntary exchange.

- **Ability-to-finance issues:** If senior debt is required from third-party lenders, it is easier to obtain here than for a voluntary exchange, in which the investor can never get 100 percent acceptance.
- **Financial commitment issues:** Mandatory exchanges usually involve megabucks, both investment and deal expenses.
- **Doability issues:** These are just like those for cash mergers and voluntary exchanges. Mandatory exchanges tend to be hard to use for hostile takeovers.
- **Social issues:** These are likely to be highly important.
- **Speed:** Mandatory exchanges are as slow as voluntary exchanges of securities, and additional time is required for a stockholder meeting after definitive materials are issued—perhaps another 20 to 60 days.
- **Rates of return:** These are similar to the rates for voluntary exchanges, except here there may be less price sensitivity on part of the OPMI market, and as is stated above, it tends to be easier to get senior financing because acquirer will be a 100 percent holder of acquire common stock. Both these factors ought to improve returns over a pure voluntary exchange.

ACQUISITION OF CONTROL WITHOUT ACQUIRING SECURITIES BY USING THE PROXY MACHINERY

With the advent of the shark repellent, hostile contests for corporate control almost invariably end up in a proxy fight; that is, the use of the proxy machinery to get the requisite voting majorities to exercise control or elements of control. The advantages and disadvantages of the proxy machinery can be examined in light of the same factors used in the examination of security purchases.

- **Pricing issues:** These are not relevant, but an outsider needs an issue or issues to obtain votes. The issue usually has to be the promise of improved future OPMI market prices.
- **Securities law issues:** These are a problem. The investor needs SEC clearance and has to defend against lawsuits by incumbents in control. Incumbents have control of both the proxy machinery and the corporate treasury.
- **Income tax issues:** Are proxy contest expenses always deductible for outsiders?
- **Availability-of-information issues:** These are not relevant.
- **Ability-to-finance issues and financial-commitment issues:** Securities are not acquired. The cost of hostile proxy solicitation usually runs well into seven figures for legal fees, printing costs (actual solicitation and fight letters), proxy solicitor fees, public relations (PR) costs, advertising costs, and the cost of courting large shareholders (e.g., Worldcom materials). If the attempt at the acquisition of control goes well, costs are likely to be recoverable because even if the hostile solicitor does not win,

the incumbents are likely to pay to get rid of him or her. The situation may be different, however, if the outside solicitor is a strategic player in the industry rather than one engaged only in a financial transaction. Nonetheless, in terms of deal expense, the company finances all of the incumbents' expenditures and none of the outsider's expenditures.

- **Doability issues:** Such acquisitions are almost always highly uncertain.
- **Social issues:** These are usually extremely important, except when the raider can win without the necessity of making any deal with the incumbents.
- **Speed:** The transaction speed varies. In most instances, outsiders cannot call a special meeting of shareholders; they have to do their thing at an annual meeting. Such meetings are supposed to be an annual occurrence for listed companies, but sometimes they can be postponed almost indefinitely.
- **Rates of return:** This is an activity with a very high potential return.

SUMMARY

Active investors seeking control or elements of control over a publicly traded commercial entity through the acquisition of securities can follow several different courses of action to achieve that goal. All acquisitions of securities are either voluntary or mandatory. *Voluntary* refers to situations in which each individual security holder can make up his or her own mind as to whether to take certain actions. *Mandatory* refers to voting situations in which all security holders are forced to participate in some action once the requisite number of security holders of that class vote in favor of the action. This chapter discusses the advantages and disadvantages of each method in light of factors such as pricing issues, securities law issues, income tax issues, other regulations, availability-of-information issues, ability-to-finance issues, financial commitment issues, doability issues, social issues, speed, and rates of return.

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Part Four

Understanding Resource Conversion

CHAPTER 22

A Short Primer on Resource Conversion*

[Long-Term Arbitrage between OPMI Prices and Control Values](#)
[More Aggressive Employment of Existing Assets](#)
[Merger and Acquisition Activity](#)
[Corporate Contests for Control](#)
[Going Private and Leveraged Buyouts](#)
[Summary](#)

If a deal maker were to think about theories of efficient markets, he would conclude that if there were efficient markets at all, there would be two efficient markets—one measuring the prices at which outsiders trade common stocks in the open market, and the other reflecting the value of businesses. Prices, or values, in one market usually would be unrelated to prices, or values, in the other. Put simply, the dealmaker would conclude that prices paid for common stocks for investment purposes are different from prices paid for control of businesses. Frequently, the value of control of businesses would be below the market price of common stocks. In that instance, the activist would seek to sell common stock owned personally, and/or have the controlled company issue new common stock. New common stock would be issuable through the sale to the public, for cash, of new issues, or through issuing new securities in merger and acquisition transactions. These types of activities are described in detail in the later chapters where we discuss the Schaefer Corporation and Leasco Data Processing transactions, which are representative of what most of the new-issue boom of the late 1960s was all about.

On the other hand, insiders frequently will conclude that the market prices of common stocks are materially below the values of the businesses these common stocks represent. In that event, insiders, promoters, or companies themselves seek to acquire common stocks at prices that represent some differential between the values being ascribed to noncontrol shares in the outside passive minority investor (OPMI) market and the value of the enterprises. We cover examples of common stocks selling well below intrinsic value or control value in mid 2012 in the section of Chapter 6 titled “OPMI Investing in Companies with Growing NAVs.”

LONG-TERM ARBITRAGE BETWEEN OPMI PRICES AND CONTROL VALUES

The two disparate markets described above exist for the same commodity—common stocks. That valuations ordinarily should be different between these two markets seems obvious. After all,

when valuing whole businesses the standards of analysis and the decision considerations tend to be different from when trying to predict market prices for common stock. Business buyers frequently use, as an essential part of judging the attractiveness of an issuer, the same elements we have described elsewhere in this book, which are also used by OPIMs following the fundamental finance approach (Chapters 8 and 15):

The conditions for an issuer to be attractive to a fundamentalist buyer include:

1. Quality of the issuer

a.Strong financial position, that is, an ability for the business to obtain credit on attractive terms:

i.Relative absence of liabilities

1. On-balance-sheet

2. Off-balance-sheet

3. Out there in the world

ii.Valuable assets (cash or near cash)

iii.Free cash flows from operations

b.Reasonably well managed and by honest people either present or potential after a change of management

c.Understandable business, which always means comprehensive disclosures and audited financial statements

2. Terms of various issues in the company's capitalization as well as legal status of the corporation based on state of incorporation and an examination of, *inter alia*, the articles of incorporation and bylaws.

3. Price of the issue

a.Common stock sells in OPIM markets at reasonable discounts from its worth to a control buyer (say a discount of 20 percent or more)

In contrast, the conventional fundamentalist or stock trader usually emphasizes the near-term outlook, which in turn involves judgments about technical positions and earnings per share as well as price-earnings (P/E) ratios, which are heavily influenced by the particular company's industry identification. Top-down forecasts, such as for interest rates or gross domestic product (GDP) are almost always very important in conventional analysis.

The market for companies and control of them appears to be, on its own terms, a highly active one, especially during periods when:

- Funds are available for borrowing, and/or
- Resource conversion—conscious insiders control companies whose common stocks are selling at high enough prices so that something is to be gained by issuing those shares in merger and acquisition activities. If a broker or finder believes he has a doable deal in terms of control, he has no trouble finding potential buyers to look at the company he proposes to offer.
- Hedge fund sponsors can finance leveraged buyouts (LBOs).

Thus, there is a long-term arbitrage that takes place because of the disparities between prices in OPIM markets and control values. But this arbitrage is far from a perfect one, in part because people in control of companies whose stock market prices are depressed are sometimes not resource conversion—conscious or may not want to take advantage of the low stock market prices by having the company acquire publicly held shares, having the insiders acquire the shares, or having a third party acquire shares by direct purchase, merger, or acquisition.

EXAMPLE

For example, back in the early 1970s, Baker Fentress, a registered closed end investment trust, was selling at around 44; its unencumbered asset value, easily measurable, was not less than \$63 per share; and even after allowing for capital gains taxes and liquidation expenses, minimum net asset value would be well in excess of \$50 per share. As a matter of fact, because certain controlled affiliates appeared to have values substantially in excess of the market prices used to determine Baker Fentress's net asset value, it was a fair guess that a realistic liquidating value for the Baker Fentress common stock could approach \$80 per share.

Through stock ownership, the Baker Fentress management and control group appeared, at least to the outsider, to be firmly in control, and there seemed to be little to indicate that there was any significant interest of management in taking those corporate actions that would result in the market price of the Baker Fentress stock rising so that it more nearly approached Baker Fentress's value as determined under a fundamental finance approach.

Baker Fentress appeared to be an attractive investment using our approach, because the stockholder would benefit from having competent investment management working to enhance, for the benefit of the stockholder, a good grade, unencumbered asset value that the stockholder acquired at a substantial discount from a reasonable measure of net asset value. Yet, it was easy to understand why the Baker Fentress common stock might have lacked appeal for the activist and the aggressive outsider. Baker Fentress did not appear to be a doable deal. There was little, if any, evidence

that any resource conversion activities would occur for the benefit of Baker Fentress security holders. The same seems true in 2012 for many issuers, such as Brookfield Asset Management, Capital Southwest, Cheung Kong Holdings, Henderson Land, Investor A/B, and Wheelock & Company among others.

Many OPMIs emphasizing the fundamental finance approach ought to be able to achieve more than satisfactory long-term investment results, even if they do not consider the prospects for resource conversion part of their investment approach. These results seemed attainable by acquiring Baker Fentress common stock and similar equity securities.

Equity investments in sound businesses (quality of the issuer) bought at what are perceived to be low prices (price of the issue) based on long-term business standards of valuation can bring the investor not only comfort but above-average returns. Comfort is created because the investor is minimizing investment risk:

- The investor is in a conservative position since he has purchased a high-quality issuer, and has done so at significant discounts from readily ascertainable net asset value (NAV).
- By definition, the businesses in which he is investing have been run conservatively.

Above-average return over the long term ought to be achievable, too, because:

- If the purchase price for stock is low relative to the value of the net assets being acquired (significant discounts from readily ascertainable NAV), prospects ought to be reasonably good for appreciation.
- In the absence of readily identifiable catalysts that may trigger a resource conversion event, an added margin of safety and assurance of adequate return are reasonable probabilities of growth in NAV over time.

After all, if on this basis, a company earns an average return on the value of assets employed in a business, investors whose stock purchase prices represent a substantial discount from that asset value will enjoy above-average returns, based on that investor's cost for his stock. Reasonable growth in NAV going forward will only make that return even larger. This is discussed in some detail in Chapter 6 on net asset value.

EXAMPLE

As we have already described in Chapters 1 and 6, it is feasible in mid-2012 as a total return investor to buy into blue chip common stocks that have the following characteristics and that in our opinion,

probably haven't been as attractively priced in mid-2012 since the mid-1970s:

- Super-strong financial position (quality of issuer).
- Common stock priced at an attractive discount from NAV of 20 percent or more (Wheelock and Company at a discount of about 50 percent) (price of the issue).
- Full comprehensive disclosures in English with audits by the Big Four (thorough analysis, based on both qualitative and quantitative grounds).
- Trading in markets where protections for OPMIs are strong.
- Prospects seem good that over the next three to eight years NAV will grow by not less than 10 percent compounded annually after adding back dividends. If such growth is achieved, the investments seem very likely to be profitable because if not, the discounts from NAV would have widened to unconscionable levels. We discuss the issue of growth in NAV in Chapters 6 and 12.

However, such an approach is unsatisfactory for activists and more aggressive outsiders. They need doable deals in which the probabilities are that resource conversion events will take place (so that someone will pay them substantial premiums above market for their stockholdings), or in which net assets in a business will be employed more aggressively in the future than in the past, either by the present control group or a new group.

Trying to spot doable deals before they are announced is something we describe as prearbitrage or predeal activities. After deals are rumored or announced, market activity tends to be dominated by professional arbitrageurs, a coterie of Wall Street people who, as a group, are extremely competent, well financed traders, who enjoy low transaction costs and who also tend to be astute in judging when and how doable deals that have been announced will be consummated. During periods when professional arbitrage activities are under way, it frequently is difficult for nonprofessional arbitrageurs to compete.

In contrast, we believe there often are important, relatively noncompetitive opportunities for OPMIs in prearbitrage activities and in postarbitrage periods.

Uncovering prearbitrage doable deals, insofar as those deals involve mergers and acquisitions or tender offers, not only creates investment opportunities, but also creates finders' and brokers' fee opportunities. As is detailed in the Leasco case in Chapter 26, in the vast majority of instances the ability to spot doable deals entails using a combination of the fundamental finance approach and personal relationships, or know-who. It seems to us that very few deals are even contemplated that are not going to be negotiated transactions, and negotiations, by definition, always involve know-who. A notable exception is asset sales under Section 363 of Chapter 11 of the bankruptcy statute, where an auction is required.

However, even without any know-who, investors using fundamental finance standards may have opportunities for uncovering doable deals merely by the study of publicly available documents describing situations in companies whose securities appear attractive, even though it has been our experience that without know-who, predicting just what situations will prove to be doable entails as much luck as skill.

Doable resource conversion activities that might be spotted include:

1. More aggressive employment of existing assets
2. Merger and acquisition activities

3. Corporate contests for control

4. Going private, including LBOs

Examples of situations where doable deals could have been spotted on a prearbitrage basis or a detailed description of the necessary conditions for a doable deal are presented next.

MORE AGGRESSIVE EMPLOYMENT OF EXISTING ASSETS

In 1974 and 1975, a group headed by Frederick Klingenstein of Wertheim and Company acquired control of Barber Oil Company, listed on the New York Stock Exchange. The Klingenstein group paid an average price of about \$25 for their position in Barber Oil, an investment company registered under the Investment Company Act of 1940, whose net asset value was stated to be approximately \$40 per share. As a business, Barber Oil was unencumbered, and it consisted essentially of a pool of capital amounting to approximately \$100 million, part of which was invested in marketable securities of major oil and gas companies, part of which was in interests in oil and gas properties, and part of which was in oil tankers. After the Klingensteins acquired control, the price of Barber Oil declined for a protracted period. The shares were available at prices ranging from approximately 17 to 21. In 1976, Barber Oil announced that it would seek to be deregistered as an investment company and that henceforth it would employ its resources to aggressively expand in the energy business, using its unencumbered equity base of \$100 million as the foundation for an acquisition program that would be financed by incurring debt. In short order, additional oil properties were acquired as well as a large coal company, Paramount Coal. In early 1978, Barber Oil was trading around \$27 per share.

MERGER AND ACQUISITION ACTIVITY

Since its founding in the early 1920s, Amerada Petroleum, a debt-free company, had built up one of the largest reserves of oil and gas in the United States, and by 1968 Amerada also had important interests in Libya. The company engaged only in oil and gas exploration and production having no downstream capabilities (that is, it did not transport, refine, or market petroleum products). Amerada also had a substantial cash surplus. In 1968, the Hess Oil and Chemical Company purchased from The Bank of England a 9 percent interest in Amerada at a price of 80. Up until that time, the Amerada stock had never sold as high as 80. Within a year of the Hess Oil and Chemical purchase of Amerada, the chairman of the board of Amerada, Mr. Jacobsen, died. Leon Hess, the head of Hess Oil and Chemical, obtained a seat on the Amerada board. Shortly thereafter a merger was proposed under which the Amerada stock worked out at a market value of not less than \$125. After Hess had acquired its 9 percent interest and before Mr. Hess obtained board representation, the Amerada shares still could have been acquired for less than 80.

CORPORATE CONTESTS FOR CONTROL

The 1970s through 2012

Back in the late 1970s and 1980s contests for control took the form of cash tender offers, a far less cumbersome takeover mechanism than engaging in proxy contests or offering to acquire target companies' common stocks in exchange for the acquiring companies' securities. Corporations that were candidates for contested takeovers were those with the following conditions:

- The companies were incorporated and domiciled in states where there are no strong antitakeover statutes.
- Share ownership was widespread or there were blocks that might be tied up via private transactions.
- There was a possible low will of the management to resist a takeover attempt; there was a general absence of impediments to the takeover, such as a company's being in a regulated industry (say, insurance, commercial banking, or aviation).
- There did not appear to be antitrust problems.
- There did not appear to be important people or institutions, such as customers, employees, or suppliers, who could harm the takeover target by terminating relationships with the company.

One example of a contested tender offer was the November 1975 cash tender by Babcock International, a subsidiary of Babcock and Wilcox, for all the shares of the American Chain and Cable Company at 27 net per share, in cash. Prior to the tender offer, the shares had traded in 1975 in a range between 14 and 20. American Chain was a New York corporation, its management held little stock, and it was not in a regulated industry. Initially, American Chain and Cable resisted the offer, but when Babcock raised the price to 32 in December, the new offer was approved by the American Chain and Cable management, several members of which obtained employment contracts.

There were scores of contested cash takeovers in the period between 1975 and 1978, including those for the common stocks of Allied Thermal, Husky Oil, Apco, Otis Elevator, ESB, Aztec Oil and Gas, Sea World, Babcock and Wilcox, Marcor, Royal Industries, and Carrier Corporation.¹ In 2012, it seemed most hostile takeovers were initiated by distressed investors who acquired credits in troubled companies and then in a Chapter 11 reorganization received common stock for their credits as part of a plan of reorganization.² This is the way Brookfield Asset Management obtained control of General Growth Properties in 2011; how John Paulson obtained control of certain resort hotels; and how Cavco Industries in partnership with Third Avenue Value Fund obtained control of Palm Harbor Homes in 2011.

The Emergence of the Shark Repellent

Today, obtaining control through an outright tender offer is a relative rarity, however, given the almost universal presence of shark repellents, which insulate existing management in office.

It is claimed, almost universally, that shark repellents are put into corporate charters and bylaws to protect OPMI shareholders from raiders who, in the absence of such repellents, would obtain control of companies on the cheap. These repellents include:

- Poison pills
- Blank-check preferred stocks
- Due on change-of-control covenants in loan agreements
- Staggered elections for members of boards of directors
- Restrictions on the ability of outsiders to convene stockholders' meetings
- Supermajority voting provisions in which changes of control may be involved

- Certain fair-price provisions

There is considerable merit to the observation that when an otherwise unwelcome acquirer has to negotiate at arm's length with an incumbent management and its board of directors, pricing for OPMI shareholders will be better than if all the acquirer had to do to obtain control was to buy directly from OPMIs enough common stock, either at the OPMI market price or at some premium over OPMI market price. This is far from the whole story, though.

The fact seems to be that when acquirers have to negotiate with managements, managements are likely to take some part of the premium paid for control for themselves, rather than giving it wholly to shareholders. If an otherwise unwelcome acquirer can obtain control by going directly to shareholders, he or she need not make special deals with management. If that acquirer negotiates with management, management is unlikely to work exclusively in the best interests of shareholders to the exclusion of seeking management's own rewards. This is just part and parcel of a financial world characterized by communities of interest and conflicts of interest.

Furthermore shark repellents should be looked at from the point of view of acquirers who might be unwelcome to an incumbent management. When potential acquirers see such repellents, they can assume that garnering control is likely to not only be more costly than would otherwise be the case but also—and perhaps more importantly—that it is likely to be uncertain, perhaps not doable at all. Many would-be acquirers conclude that attempting this takeover is not worthwhile. The existence of shark repellents, in an efficient world, has to mean that there are fewer changes of control that would result in OPMIs receiving premiums over market than would otherwise be the case.

Intuitively, it would seem that the OPMI community is probably hurt more by repellents than it is helped. Given that OPMI market prices tend to be irrational compared with a fundamental finance approach, however, it can be safely said that OPMI prices do not reflect managements' abilities to run businesses. Put simply, OPMI prices do not serve as a good test distinguishing between competent managements who deserve to be insulated in office and poor managements who ought to be removed from office.

From a national interest or national productivity point of view, there appears to be ample justification for repellents despite disadvantages to OPMIs because the country would be a lot less productive if managements in general had to run companies by concentrating on the daily stock ticker and reported quarterly earnings per share. Although shark repellents seem justified from a national-interest point of view, many repellents, including poison pills and Pennsylvania corporate law, seem to constitute overkill. The Pennsylvania antitakeover statutes, for Pennsylvania corporations opting to take advantage of Pennsylvania law, in effect seem to bulletproof incumbents in office.

Revlon rules exist in Delaware, the leading state for the incorporation of companies whose common stocks are traded publicly. Put simply, these rules state that if control of a company is to change—whether hostile or friendly—the role of a board of directors changes. The board becomes an auctioneer, and its duties are to obtain the best price, and other terms, that can be obtained for stockholders. The same trade-off seems to exist under *Revlon* rules as exist under shark repellents from an OPMI point of view. *Revlon* rules probably result in there being better pricing than would otherwise be the case and probably also mean that there will be fewer deals at premiums over OPMI market prices than would otherwise be the case.

GOING PRIVATE AND LEVERAGED BUYOUTS

Tax Shelter (TS), Other People's Money (OPM), and

Something off the Top (SOTT)

People and companies rarely act unless they expect a resulting benefit, either for themselves or for others with whom they have identities of interest. In making such decisions, the actors aim to take advantage of certain factors that seem to be present in many resource conversion activities. There are three such factors, and going private transactions are a resource conversion activity where different participants take advantage of these factors.

The first factor, and the one that probably has the single most pervasive influence on our economy, is tax considerations. Actors seek to maximize profits by minimizing their tax liabilities. In its ultimate form, tax shelter (TS) exempts the taxpayer from tax altogether; but it may also involve structuring a transaction in special ways so as to achieve a preferential tax rate on the profits realized or to allow the taxpayer to control the timing of the tax liability.

A second factor is other people's money (OPM, pronounced OPIUM). OPM can take many forms. The most familiar of these is, of course, the conventional borrower-lender relationship, where a person pays fees for the privilege of using someone else's money. The user of OPM may, however, obtain his money without direct payment of fees. For example, commercial banks obtain demand deposits without paying interest on them; insurance companies obtain prepayment of premiums on the policies they issue. The users of OPM may even obtain profits from the very providers of funds. LBO sponsors normally take an investment-banking fee for arranging the LBO transaction. After the deal is closed, the sponsor usually takes a regular management fee. In leading private equity funds, these fees generally belong to the general partners (GPs) and are not shared with the investors who are limited partners (LPs). This is so also in the case of insurance companies that make money not only by investing the cash created by the prepayment of premiums, but also from the operations of the insurance business itself for which the premiums are paid.

Finally, many people involved with corporations try to obtain other benefits out of the association for themselves or for the corporation. This is the third factor, and we characterize all such benefits as something off the top (SOTT), which means different things to different users of it. For example, to a company, SOTT may mean diversified income, freedom from regulation, and political clout. To a public company, it may also mean control of the registration process, together with an ability to sell equity securities at an ultrahigh price, so that new productive assets can be obtained on an advantageous basis via either a public offering or a merger and acquisition program. To management, SOTT means not only salaries, bonuses, stock options, expense accounts, and perquisites such as prestige and big offices, but also power and operating control. In a public company, this includes control of the registration process and proxy machinery. Finally, not being an insider can occasionally even serve as a form of something off the top to those outside securities holders who eschew any of the responsibilities that go with being an insider, and who want nothing more than absolute passivity, liquidity, and marketability.

The Example

Take a simplified hypothetical example of a going-private transaction to illustrate these factors.³ XYZ is an ordinary non-growth public company with 1 million shares of XYZ common stock outstanding. XYZ is debt free. The common stock sells around 9½ in the outside passive minority investor (OPMI) market, giving the common stock an aggregate market value of around \$9.5 million.

Going forward for the next five years, XYZ is to have annual operating income of around \$2 million including interest income of 6 percent on surplus cash held (i.e., cash holdings in excess of \$500,000). During this five-year period, the aggregate amount of receivables outstanding and inventory will remain constant at \$2 million. Current liabilities remain constant at \$600,000. Cash necessary for the operation of the business is assumed to be constant at \$500,000. The value of the property, plant, and equipment (PPE) account will remain constant at \$6 million, as capital expenditures for PPE will exactly equal charges taken for depreciation and amortization of PPE.

Prior to any financial engineering, the XYZ balance sheet and income account were as shown in [Tables 22.1](#) and [22.2](#), respectively.

Table 22.1 Summary Balance Sheet for XYZ

Variable	Value (000)	Variable	Value (000)
Cash	\$1,000	Current Liabilities	\$600
Receivables and Inventory	\$2,000		
Property, Plant, and Equipment (PPE)	\$6,000		
		Net Worth	\$8,400
Total Assets	\$9,000	Total Liabilities + Equity	\$9,000

Table 22.2 Summary of Income Account for XYZ

Variable	Value (000)
Revenues	\$7,000
Operating Income, including interest income	\$2,000
Income Taxes at 35%	\$700
Net Income	\$1,300
Earn per Share for 1,000 shares	\$1.30
Market Value of Equity at seven times earnings	\$9,100
Return on Equity	15.48%

Then Promoter Group, via Newco, a newly formed corporate shell, acquires, in a newly formed wholly owned subsidiary of Newco, all XYZ assets, subject to all of XYZ's liabilities. The acquisition of these net assets is for cash, at six times operating earnings, or \$12 million, equal to an almost 32 percent premium over the prevailing price of \$9.1 million for XYZ equity in the OPMI market. Fees and expenses of the transaction are \$500,000.

Newco obtains the \$12.5 million cash needed to close the XYZ transaction, without recourse to Promoter Group, as shown in [Table 22.3](#). [Table 22.4](#) shows Newco's opening balance sheet.

Table 22.3 Financing for Purchase of XYZ Net Assets

Source	Value (000)
XYZ Surplus Cash	\$500
Funds Borrowed from Banks at 5% (five times operating income, secured by various assets such as receivables and property, plant and equipment)	\$10,000
Investment of Cash by	\$2,000

Promoter Group limited
partnership

Total Sources\$12,500

Table 22.4 Approximate Newco Opening Balance Sheet (Consolidated)

Variable	Value (000)	Variable	Value (000)
Cash	\$500	Current Liabilities	\$600
Receivables and Inventory	\$2,000	Secured Borrowings	\$10,000
PPE	\$6,000		
Intangibles	\$4,000	Net Worth	\$1,900
Total Assets	\$12,500	Liabilities + Equity	\$12,500

Newco’s approximate, condensed income accounts, cash flow statements, and balance sheets for each of the next five years are as shown in Table 22.5, assuming the secured borrowings are amortized at a rate of \$500 per year.

Table 22.5 Newco Forecasted Financial Statements (post LBO) (\$2,000 Common Stock Investment)

		End of				
	Opening	Year 1	Year 2	Year 3	Year 4	Year 5
Balance Sheet						
Cash	\$500	\$500	\$500	\$500	\$500	\$500
Acct. Rec & Inv	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000
PPE	\$6,000	\$6,000	\$6,000	\$6,000	\$6,000	\$6,000
Intangibles*	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000
Total Assets	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500
Current Liabilities	\$600	\$600	\$600	\$600	\$600	\$600
Secured Borrowing Outstanding	\$10,000	\$9,025	\$8,018	\$6,979	\$5,906	\$4,798
Net Worth	\$1,900	\$2,875	\$3,882	\$4,921	\$5,994	\$7,102
Total Liabilities + Equity	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500
Income Account						
Operating Income	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000
Impairment of Intangibles		\$-	\$-	\$-	\$-	\$-
Interest on Secured Debt @ 5%		\$500	\$451	\$401	\$349	\$295
Income Tax @ 35%		\$525	\$542	\$560	\$578	\$597
Net Income		\$975	\$1,007	\$1,039	\$1,073	\$1,108
Sources and Uses of Funds						
Sources of Funds						
Net Income		\$975	\$1,007	\$1,039	\$1,073	\$1,108
Impairment of Intangibles		\$-	\$-	\$-	\$-	\$-
Total Sources		\$975	\$1,007	\$1,039	\$1,073	\$1,108
Uses of Funds						
Repayment of debt		\$975	\$1,007	\$1,039	\$1,073	\$1,108
Total Uses		\$975	\$1,007	\$1,039	\$1,073	\$1,108
Net Cash		\$-	\$-	\$-	\$-	\$-
Beginning Cash		\$500	\$500	\$500	\$500	\$500
Ending Cash		\$500	\$500	\$500	\$500	\$500

*Intangibles are tested for impairment each year and are assumed not to be impaired during the forecast period.

Table 22.6 is a clone of Table 22.5, except that the equity investment into Newco is \$1,000 rather than \$2,000. The \$1,000 cash needed to close is obtained by having Newco sell, for \$1,000 cash, a new parent company issue of \$1,000 principal amount of nonamortizing 10-year, 8 percent subordinated debentures. These junk bonds are a form of mezzanine finance.

Table 22.6 Newco Forecasted Financial Statements (post LBO) (\$1,000 Common Stock Investment)

		End of				
	Opening	Year 1	Year 2	Year 3	Year 4	Year 5
Balance Sheet						
Cash	\$500	\$500	\$500	\$500	\$500	\$500
Acct. Rec & Inv	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000
PPE	\$6,000	\$6,000	\$6,000	\$6,000	\$6,000	\$6,000
Intangibles*	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000
Total Assets	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500
Current Liabilities	\$600	\$600	\$600	\$600	\$600	\$600
Secured Borrowing Outstanding	\$10,000	\$9,077	\$8,124	\$7,140	\$6,124	\$5,075
Subordinated Borrowing Outstanding	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Net Worth	\$900	\$1,823	\$2,776	\$3,760	\$4,776	\$5,825
Total Liabilities + Equity	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500
Income Account						
Operating Income	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000
Impairment of Intangibles		\$—	\$—	\$—	\$—	\$—
Interest on Secured Debt @ 5%		\$500	\$454	\$406	\$357	\$306
Interest on Subordinated Debt @ 8%		\$80	\$80	\$80	\$80	\$80
Income Tax @ 35%		\$497	\$513	\$530	\$547	\$565
Net Income		\$923	\$953	\$984	\$1,016	\$1,049
Sources and Uses of Funds						
Sources of Funds						
Net Income		\$923	\$953	\$984	\$1,016	\$1,049
Impairment of Intangibles		\$—	\$—	\$—	\$—	\$—
Total Sources		\$923	\$953	\$984	\$1,016	\$1,049

		End of				
	Opening	Year 1	Year 2	Year 3	Year 4	Year 5
<i>Uses of Funds</i>						
Repayment of Debt		\$923	\$953	\$984	\$1,016	\$1,049
<i>Total Uses</i>		\$923	\$953	\$984	\$1,016	\$1,049
Net Cash		\$—	\$—	\$—	\$—	\$—
Beginning Cash		\$500	\$500	\$500	\$500	\$500
Ending Cash		\$500	\$500	\$500	\$500	\$500

*Intangibles are tested for impairment each year and are assumed not to be impaired during the forecast period.

Assume in Table 22.5 that at the end of five years, Newco goes public at eight times earnings, using the proceeds from the public offering (say \$2,000) to pay down secured borrowings. At eight times earnings, old equity would have an OPMI market value of \$8,864, resulting in a compound annual return of 34.7 percent. Is this a comparison of apples and oranges here—\$2,000 cash in 2012 versus \$8,864 in restricted common stock in 2017? Would it not still be apples and oranges if all the Newco common stock became freely tradable in 2017?

Assume in Table 22.6 that at the end of five years, Newco goes public, as per the preceding paragraph. At eight times earnings, old equity would have an OPMI market value of \$8,392, resulting in a compound annual return of 53.03 percent. Assume in Tables 22.5 and 22.6 that with the secured lender's permission, Newco was able to dividend out \$1,000 of surplus cash before going public. Returns of 34.7 percent and 53.03 percent would be increased materially.

In the real world, Promoter Group, as the promoter, would have received much in the way of additional compensation from the XYZ deal:

- Part of that \$500 initial expense incurred in connection with the acquisition of XYZ would have been an investment-banking fee paid to Promoter Group. The actual promoters of the deal, as general partners (GPs) of Promoter Group, may or may not have shared that investment-banking fee with the limited partners (LPs).
- Newco probably paid a home office charge to Promoter Group—say, \$100 per year.
- The typical relationship between Promoter Group's GPs and its LPs is that the GPs, which run hedge funds, get a management fee of between 1 and 2 percent per annum of assets managed, plus 20 percent of the profits, sometimes after the LPs get a minimum return, say 7 or 8 percent per annum. The GPs are unlikely to have invested any of their own funds into Promoter Group; 100 percent of the funding would have been provided by the LPs.
- Instead of a 32 percent premium's being paid to OPMI investors (assuming that old XYZ was liquidated or that Newco had purchased XYZ common stocks rather than XYZ net assets), perhaps only a 20 percent premium was paid, with the missing 12 percent going to XYZ management and control people as bonuses and parachutes.

Why did the XYZ control group need to sell to Promoter Group? The control group could have accomplished a similar transaction itself in a strict going-private, in which case not only would it have extracted cash from XYZ, taxable on a capital-gains basis, but it would also have remained in complete control of XYZ.

Alternatively, important people at XYZ could have had interests in Promoter Group or Newco common stock. There is no need for Promoter Group to own 100 percent of Newco common. Indeed, PG might have actively sought XYZ management ownership of a minority interest in Newco common.

One of the big advantages Promoter Group has as the controlling entity of Newco is complete control of timing. Promoter Group chooses when to go public. Suppose the initial public offering (IPO) market heated up in 2014. Why not take Newco public then at, say, 12 to 15 times earnings, especially since at that time publicly traded comparables might be selling in the OPMI market at 16 to 20 times earnings? There are lots of institutional pressures to have buoyant IPO markets:

- A large number of Promoter Group-type entities are either associated with major underwriters (Goldman Sachs, Merrill Lynch, and Morgan Stanley) or have close relationships with them.
- Securities salespeople love and need underwritings because of (1) large gross spreads, a substantial portion of which is paid to salespeople, and (2) exclusive products (Newco, now renamed XYZ, common stock as an IPO), designed to sell at premiums in immediate aftermarkets and usually unavailable to discount brokers.
- In going public, use of proceeds becomes a very important consideration. In Newco's situation, cash proceeds from an IPO could have gone in three general directions: the expansion of operations (i.e., investment in new assets), the paying down of senior borrowings, or payments on junior securities, subordinates, or common stock. (If presently outstanding common stock is sold in the IPO, this is called a secondary.)

Assume that Newco had substantial amounts of net loss carryforwards to shelter XYZ earnings before income taxes and that the \$12,500 acquisition of XYZ net assets for cash left intact, for income-tax purposes, Newco's continuity of ownership and continuity of business. Cash flows available from the transaction would, of course, be increased materially. So would Generally Accepted Accounting Principles (GAAP) book value as per GAAP rules as promulgated in Financial Accounting Standards Board (FASB) 109. Under FASB 109, Newco would have capitalized as an asset the present value of estimated cash to be generated via use of the net operating loss tax carry forward.

As part of control of timing, suppose Newco goes public by way of an IPO and prospers, but the aftermarket is very poor, so that the OPMI market price is four times earnings. Promoter Group takes Newco private at six times earnings; stockholder suit is brought and settled on the basis of a \$50,000 fee to class-action attorneys, and the stock price is increased by 25 cents per share. No Newco stockholder perfects rights to a statutory appraisal.

Suppose Newco falters and is unable to service debt to secured lenders, the trade creditors, or the subordinates. Either in court (Chapter 11 reorganization) or out of court (a voluntary restructuring), Promoter Group, as control people and as a debtor in possession (DIP), will have a tremendous amount of control over the reorganization processes.

Suppose Promoter Group wanted to acquire control of XYZ in a hostile takeover. It would have the benefit of not necessarily having to make a deal with XYZ management or control groups. If it owned a minority position in XYZ common stock, Promoter Group could serve as the catalyst that would put XYZ in play. There would be many disadvantages to a hostile takeover, including quite high administrative expenses, whether Promoter Group seeks to acquire XYZ common stock, presumably for cash, or solicits proxies for control. There are always lots of uncertainties in engaging in hostile takeovers, and Promoter Group would be estopped from doing due-diligence research away from public records.

Suppose Newco were a public company selling at 25 times earnings and wanted to acquire XYZ in a merger transaction, exchanging a new issue of Newco common stock for all of the 1,000 shares of XYZ common stock outstanding. Newco currently has 1,000 Newco common shares outstanding and has net income of \$1,000 and therefore an OPMI market capitalization of \$25,000, or \$25 per share. It acquires XYZ for \$15 market value of a new issue of Newco common

stock. This equals a premium of about 56 percent over the XYZ common stock OPMI trading price. It requires the issuance of 600 shares of Newco common stock. As a result of the transaction, Newco's net income will be increased from \$1.00 per share to \$1.38 per share, as shown in [Table 22.7](#).

Table 22.7 How NEWCO's Net Income Increases in a Merger

Variable	Value (000)
Newco Net Income	\$1,000
XYZ Net Income	\$1,200
Combined Net Income	\$2,200
Earnings per Share (1,600 shares)	\$1.38

SUMMARY

There is a long-term arbitrage between OPMI prices and control values. Disparities between prices in OPMI markets and control values give rise to resource conversion opportunities that we illustrate in this chapter. We also discuss how OPMIs can take advantage of relatively noncompetitive prearbitrage or postarbitrage situations. People and companies rarely act unless they expect a resulting benefit, either for themselves or for others whom they have identities of interest. In making such decisions, the actors aim to take advantage of certain factors that seem to be present in many resource conversion activities.

The tale of XYZ Company contains examples not of free lunches, but rather simplified examples of how activists engaged in financial engineering try to get other people to pay for their lunches. Getting someone else to pay for your lunch can, in the most general sort of way, fit into one or more of three categories that we introduced at the beginning of this section:

1. Something off the top (SOTT): whether promoter's compensation, managements' compensation, underwriting gross spreads, salespeople's participations, or free or cheap stock or options.
2. Other people's money (OPM): which is access to attractive outside capital, whether equity or debt, and access to attractive credit enhancements, whether for companies or other participants.
3. Tax shelter (TS) for companies and all participants with clout.

* This chapter contains original material, and parts of the chapter are based on material contained in Chapter 12 of *Value Investing* by Martin J. Whitman (© 1999 by Martin J. Whitman) and Chapter 17 of *The Aggressive Conservative Investor* by Martin J. Whitman and Martin Shubik (© 2006 by Martin J. Whitman and Martin Shubik). This material is reproduced with permission of John Wiley & Sons, Inc.

¹ The reader is referred to Chapter 21, "Buying Securities in Bulk," where we discuss many of the issues relating to the different methods of purchase of securities.

² For detailed examples of changes of control through the acquisition of the credits of troubled companies the reader is referred to Martin J. Whitman and Fernando Diz, *Distress Investing: Principles and Technique* (Hoboken, NJ: John Wiley & Sons, 2009).

³ In Chapter 25 we discuss The Hertz Corporation's going-private transaction in detail.

CHAPTER 23

Restructuring Troubled Companies*

The Five Basic Truths of Distress Investing

Rehabilitation of Troubled Entities

Summary

Distress investing is different from what most academic theorists and common stock investors are used to. Distress investing involves being a special sort of creditor. In contrast, modern capital theory (MCT), the principal academic discipline, looks at investing from the point of view of either the outside passive minority investor (OPMI) in common stocks or the common stockholder consolidated with the company itself.¹ Both approaches clearly are irrelevant for distress investing, though many MCT concepts are very helpful—for example, an expanded view of the concept of net present value (NPV).

Most so-called common stock “investing” involves trying to predict near-term market prices in most situations even where there are no reasonably determinate workouts. Weight to market is minimal in distress investing. Most credit analysis revolves around trying to predict whether there will be a money default. In distress investing we assume that there is some probability that there will be a money default. Distress investment analysis bottoms on figuring out what happens next, that is, after a money default occurs. Some senior creditors will be reinstated, and perhaps never even miss a contracted-for cash payment for interest, principal, or premium; some creditors will participate in a reorganization and receive a new package of securities (and maybe even some cash) in satisfaction of their claims; and some junior creditors and stockholders will be wiped out, receiving no value in the reorganization. Sometimes a company will be liquidated pursuant to Chapter 7 or a Chapter 11 liquidation plan. Proceeds from a liquidation will be distributed to claimants and parties in interest in accordance with the rule of absolute priority; that is, a senior class is to be repaid in full before anything is paid to a junior class. In distress investing, Chapter 11 is not an ending; rather, it is a beginning.

THE FIVE BASIC TRUTHS OF DISTRESS INVESTING

There are five basic truths that anybody wishing to be an investor in distressed situations cannot afford to ignore. These truths represent the guiding principles that guide all reorganizations, whether they take place out of court or in a court of competent jurisdiction, usually a bankruptcy court.

Truth 1: No One Can Take Away a Corporate Creditor's Right to a Money Payment Outside of Chapter 11 or Chapter 7 Unless Individual Creditor Consents

Outside of a court proceeding, usually Chapter 11, no one can take away a creditor's right to a money payment for interest, principal, or premium unless that individual creditor so consents. Ignorance of this basic rule seemed evident in the airline bailout in the fall of 2001, which, among other things, was approved by a 96-to-1 vote in the U.S. Senate. Cash payments of \$5 billion were made to the airlines, of which well over \$2 billion was used in the subsequent 12 months to pay cash interest on already outstanding airline indebtedness. None of the funds dedicated to interest payments were used to enhance the efficiency or security of airline operations. Put otherwise, the bailout seemed to be a bailout of airline creditors in great part, rather than a bailout of the airlines.

What does it mean for a distress investor?

If a company is going to avoid Chapter 11, credit instruments with a short term to maturity give the distress investor *de facto* seniority. If a company is to be granted Chapter 11 relief, seniority of credit instruments will lie in their covenants and intercreditor agreements, and maturity dates for unsecured lenders become irrelevant. The authors took advantage of the right to money payments by acquiring General Motors Acceptance Corporation (GMAC) senior unsecured notes in late October 2008. The relevant data were:

GMAC 7¾ senior unsecured notes, maturing 1/19/2010

Amount issued: \$2,500,000,000

Current price: \$62.00

Yield to maturity (YTM): 53.42%

Current yield (CY): 12.50%

Denied access to capital markets to refinance maturing obligations, the GMAC business was effectively in runoff in October 2008. GMAC had three types of assets that could be convertible to cash to meet maturing obligations:

1. Receivables and leases
2. A 100 percent interest in a profitable property and casualty (P&C) insurance company that earned \$400 million to \$600 million per year and was probably worth a sizable premium over book value
3. A one third stock interest in GMAC Bank, much of whose assets might be in residential mortgages

The three questions that a distress investor is likely to ask are:

1. Will the 7¾ notes remain performing loans?
2. Will the 7¾ notes participate in a Chapter 11 reorganization?
3. Will there be a voluntary exchange offer for the 7¾ notes run by Cerberus L.P., the principal owner of 51 percent of GMAC common stock?

Whether or not the 7¾ notes would remain a performing loan seemed to depend a lot on what the loss experience would be on the runoff of the receivables and lease portfolios. The authors did not know, but guessed there was a 70 percent to 75 percent probability that the runoff would be profitable enough to keep the 7¾ notes a performing loan through maturity. If this happened, the key performance measure for the distress investor would be yield to maturity (YTM) of 53.42 percent.

If the 7¾ notes were to participate in a Chapter 11 reorganization—a 25 percent to 30

percent probability, say—the investor would receive upon reorganization a new package of securities, probably including common stock, in what ought to become a conservatively financed finance company. Here the distress investor measures his return by the dollar price paid for the 7¼ notes and the workout value of the securities to be received in a reorganization over an estimated period of time.

Cerberus could try a voluntary exchange offer for various GMAC senior unsecured notes, including the 7¼s. The exchange offer would probably propose that the 7¼s accept a new package of securities with stretched-out maturity dates that would have an expected market value of, say, \$80 to \$85. There was no way that such an exchange offer would be accepted by most holders of the 7¼s unless the holders could have been shown some meaningful downside if they did not exchange. The one downside that we could think of that might have encouraged acceptances was that if an insufficient number of 7¼s were tendered, GMAC could file for Chapter 11 relief. Such a scenario seemed very unlikely. Cerberus, a GMAC stockholder, was not going to want to commit suicide, or even take a suicide risk, knowing what could happen to GMAC common stock in a Chapter 11 reorganization. GMAC did in fact try such an exchange offer, which predictably failed.

In the end, GMAC succeeded getting a capital infusion from the Troubled Asset Relief Program (TARP) and became a bank holding company, which gave it access to capital from the Federal Reserve. The result was that the notes became credit enhanced and quickly traded at a YTM of 12 percent.

This requirement to pay cash in the absence of Chapter 11 relief will be the case as long as that creditor is a beneficiary of either U.S. securities law or the terms contained in virtually all bond indentures and loan agreements. These rights to money payments for most publicly traded debt instruments exist because of the provisions of Section 316 of the Trust Indenture Act of 1939 (TIA), the provisions of the typical indenture issued for publicly traded bonds, and the provisions of typical loan agreements protecting institutional lenders such as commercial banks. Section 316(b) states in relevant part:

Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or effected without the consent of such holder.

The TIA contains two exceptions to this right to payment, both of which seem minor.

The first exception is contained in Section 316(a)(2):

The indenture to be qualified may contain provisions authorizing holders (except those known to the indenture trustee to be the debt issuer or insiders of the debt issuer) of not less than 75 percent in principal amount of the indenture securities or if expressly specified in such indenture, of any series of securities at the time outstanding to consent on behalf of the holders of all such indenture securities to the postponement of any interest payment for a period not exceeding three years from its due date.

The second exception is contained in the latter part of Section 316(b) of the TIA:

[S]uch indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

A corporate issuer is required to comply with the TIA if \$10,000,000 or more principal amount of debt instruments is to be marketed publicly by the issuer over a 36-month time span (Section 304(a)(9)). The TIA protection in the United States against depriving a creditor of rights to interest and principal payments does not necessarily apply in other jurisdictions, such as Canada.

The indenture for Home Products International, Inc., 9⁵/₈ percent senior subordinated notes, is typical for credit instruments complying with the TIA. Relevant language in the Home Products indenture follows:

Section 9.2. Amendments with consent of Holders: The Company, the Subsidiary Guarantors and the Trustee may amend this Indenture or the Securities without notice to any Security holder but

with the written consent of the Holders of at least a majority in principal amount of the Securities. However, without the consent of each Security holder affected, an amendment may not:

- (1) reduce the amount of Securities whose Holders must consent to an amendment;
- (2) reduce the rate or extend the time for payment of interest of any Security;
- (3) reduce the principal of or extend the Stated Maturity of any Security;
- (4) reduce the premium payable upon the redemption or repurchase of any Security or change the time at which any Security shall be redeemed or repurchased in accordance with this Indenture;
- (5) make any Security payable in money other than that stated in the Security;
- (6) impair the right of any Holder to receive payment of principal of and interest on such Holder's Securities on and after the due dates therefore or to institute suit for the enforcement of any payment on or with respect to such Holder's Securities;
- (7) make any change to the amendment provisions which require each Holder's consent or to the waiver provisions.

Typical language contained in a loan agreement for debt syndicated among commercial banks is contained in a 1996–1997 “Credit Agreement among Safelite Glass Corp., Various Lending Institutions and the Chase Manhattan Bank as Administrative Agent” and follows in “Section 12.12 Amendment or Waiver; etc.”:

(a) Neither this Agreement nor any other Credit Document nor any terms hereof or thereof may be changed, waived, discharged or terminated unless such change, waiver, discharge or termination is in writing signed by the respective Credit Parties party thereto and the Required Banks, provided that no such change, waiver, discharge or termination shall, without the consent of each Bank (other than a Defaulting Bank) with Obligations being directly affected thereby in the case of the following clause (i), (i) extend the final scheduled maturity of any Loan or Note or extend the stated maturity of any Letter of Credit beyond the Revolving Loan Maturity Date, or reduce the rate or extend the time of payment of interest or Fees thereon, or reduce the principal amount thereof, or amend, modify or waive any provision of this Section 12.12.

This inability in the United States for anyone outside of a court proceeding to take away a creditor's right to a money payment unless the individual creditor consents is extremely important both to corporate managements and to creditors.

Truth 2: Chapter 11 Rules Influence All Troubled Company Reorganizations

In the reorganization of any publicly traded issuer, whether that reorganization takes place out of court or in Chapter 11, the rules governing a Chapter 11 reorganization will influence heavily the actual reorganization that eventually takes place. These rules include the *rule of absolute priority* and the *period of exclusivity* during which the debtor is the only party who can propose a plan of reorganization (POR).

If a financially troubled company, especially a large company with publicly traded securities, is required to recapitalize, it will have three choices:

- 1. Voluntary exchanges.** The company may seek to exchange new and more liberalized securities for the outstanding securities. In connection with these voluntary exchange offers, the company frequently will seek consents from each creditor or security holder to delete or amend restrictive covenants in the indentures or agreements under which the

instruments were issued. Exchange offers and consent solicitations rarely work satisfactorily. Exchange offers frequently fail because they are premised on the often-fallacious assumption that creditors will accept an instrument with more immediate market value (as opposed to inherent or potential value) in exchange for outstanding debt securities that have a currently depressed market value (see earlier GMAC example). The one factor that frequently induces creditors to agree to voluntary exchanges is to show the creditors that there is a significant downside risk for them if they do not participate in the offer. This can often be made to be the case if exchanged debt instruments are granted seniority over nonexchanging debt instruments. Even if an original bond indenture prohibits the issuance of senior debt, that provision can be abrogated by the consent of the requisite amount of bonds: in the case of Home Products International, “the written consent of the Holders of at least a majority in principal amount of the Securities” (Section 9.2 of the indenture). Agreeing to the exchange offer can constitute a written consent.

2. Conventional Chapter 11. The company may first file a bankruptcy petition under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Chapter 11, Title 11 of the U.S. Code) and then attempt to recapitalize by soliciting acceptances of a plan of reorganization. This conventional approach to bankruptcy in most situations entails considerable risk and uncertainty for the company and its management. In a Chapter 11 bankruptcy, each of the company’s creditors and sometimes its stockholders is a party to the proceeding with standing to object to any and all transactions outside the ordinary course of business. These creditors and stockholders are represented by official committees having significant voice in the administration of the bankruptcy and are generally well represented by active and aggressive attorneys, accountants, and investment bankers. The Bankruptcy Code provides that there be appointed an official Committee of Unsecured Creditors. However, additional committees representing other constituencies are often appointed also. Each of these parties in interest will likely press its own agenda. In addition, the company will end up funding huge administrative expenses because it will be required to pay the fees and expenses of not only its own attorneys, accountants, and investment bankers, but also the attorneys, accountants, investment bankers, and other agents for various claimants and parties in interest. This tends to be the case whether the reorganization takes place in Chapter 11 or via voluntary out-of-court exchanges.

3. Prepackaged or prenegotiated filings. Pursuant to Section 1126(b) of the bankruptcy code, the company may solicit requisite consents to its bankruptcy reorganization plan *before* filing for Chapter 11 relief. Such solicitations commenced prior to filing for Chapter 11 relief may now continue past the filing date based on the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). If such consents are obtained, the company then will file for Chapter 11 for the limited purpose of getting the plan of reorganization confirmed by a bankruptcy court. Obtaining consents prior to filing for a Chapter 11 relief

dramatically reduces the uncertainty, risk, and expense involved when a company attempts to recapitalize. Prepackaged bankruptcy reorganization is the ideal method for recapitalizing certain types of public companies. Good candidates are those troubled companies with relatively stable and predictable sources of operating income from core businesses and those with fairly simple capitalizations involving conventional debt and only small amounts of contingent liabilities.

Whether the company being recapitalized is healthy or financially troubled, the techniques used to recapitalize have to be either voluntary or mandatory. Voluntary techniques (such as exchange offers) are those where each security holder will make an independent decision whether to accept the offered recapitalization. If the security holder does not elect to accept the voluntary offer, there will be no change to the entitlements to interest and principal in accordance with the terms of his or her instrument. Mandatory techniques (such as freeze-out mergers in the case of healthy companies, and Chapter 11 bankruptcies in the case of financially troubled companies) involve a compulsory change to the instruments of dissenting security holders if the required threshold of acceptances is received. Mandatory techniques almost always entail use of the voting process and proxy machinery, which machinery is almost always within the absolute control of management when a healthy company is involved, but is rarely within the absolute control of management when a troubled company is involved.

Reorganization of a troubled company, whether through the voluntary exchange of securities or through relief under Chapter 11, involves, in the final analysis, recapitalizing a company. Successful recapitalizations invariably involve reducing, delaying, or eliminating contractual requirements that the company make cash interest or principal payments. Healthy companies also reorganize (i.e., recapitalize), even though such reorganizations/recapitalizations almost always involve increasing as opposed to reducing the company's obligations to make cash payments to creditors. Recapitalizations of healthy companies go under such names as leveraged buyout, management buyout, cash-out merger, purchase, and going private.

Truth 3: Substantive Characteristics of Securities

John Burr Williams, an eminent economist, wrote in 1938, "Investment value is the present worth of the future dividends in the case of a common stock, or of the future coupons or principal in the case of a bond." Williams had it wrong in terms of analyzing distressed situations. Here, investment value is the present worth of a future cash bailout, whatever the source of that cash bailout.

A security gives a holder either rights to cash payments by a company or ownership rights in that company, present or potential. If the promise of cash pay as scheduled is legally enforceable, the security is a debt obligation or credit instrument. If the promise of cash pay as scheduled is not a legally enforceable right except in very limited circumstances (e.g., neither the declaration of a common stock dividend or repurchases of outstanding common stock can be made unless cash payments are first paid to a security with seniority over the common stock), the security is a preferred stock. If the security combines the promise of cash pay with ownership rights—present or potential—the security is a hybrid, either a convertible debt or convertible preferred, or a unit consisting of a credit instrument or preferred stock and detachable or nondetachable warrants or common stock. A security with ownership rights but no contractual or legal rights to receive cash pay is a common stock.

As was discussed already in Chapter 4, for a security to have value, it has to have the promise of delivering a cash bailout to a holder. Cash bailouts come from three disparate sources:

1. Payments by the company, whether for interest, principal, premium, dividends, or share repurchases.
2. Potential sale to some sort of a market, not just an outside passive minority investor (OPMI)—a market such as the New York Stock

Exchange, but also other markets, such as takeover markets.

3. Control or elements of control of the company. Common stocks without economic value can sometimes have a governance value.

A common stock that does not pay a dividend has value to a holder only if it provides either a market-out or elements of control (also, but rarely, nuisance value). Many if not most recipients of common stocks upon the consummation of a plan of reorganization (POR) are passive rather than control investors. For example, commercial banks and insurance companies by definition are noncontrol investors. Frequently, they are required to take common stock in a POR, as was the case in the 1985 reorganization of Anglo Energy when they received 75 percent of the new Anglo common stock. Rule 1145 of the bankruptcy code at that time prevented persons getting 5 percent or more of the common stock to be outstanding from selling those shares in public markets unless they were held, fully paid, for one year, after which common shares could be dribbled out weekly at the greater of 15 percent of the daily volume or 1 percent of the outstanding issue. Regulators and others promulgate Rule 1145 and others like it (SEC Rule 144) because they fear share price declines in common stock markets if blocks of common stock are dumped. This fear factor seems much worse in Japan than in the United States, where large amounts of cross-holdings, especially common stocks held by commercial banks, are frequently restricted from being sold in the open market. This seems mistaken policy. It is much more important to have PORs become feasible by giving noncontrol shareholders easy market-outs so that they become willing recipients of common stocks in PORs than it is to provide price supports for OPMI stock markets, which are bound to price securities capriciously in any event.

A disconcerting development revolves around bankruptcy court rulings that prohibit sales by creditors who are likely to receive common stocks in a reorganization in order to permit companies to preserve the value of net operating losses that would be compromised if, for purposes of Section 382 of the Internal Revenue Code, there were to be a change of ownership. One example is the 1994 Phar-Mor Chapter 11 case heard in the Northern District of Ohio. For noncontrol shareholders owning non-cash-pay securities, those securities have little or no value unless the security holder is provided with a market-out sooner or later, preferably sooner.

Control securities are a different commodity from passive securities from an economic point of view even though they are indistinguishable in legal form. As an example, a security with no apparent value to a holder would be a nonmarketable, non-dividend-paying, minority-interest common stock where the holder has no nuisance potential. A similar situation where there is apparent value to a holder is that of a security that is a deeply underwater common stock where the holder is the debtor in possession (DIP) enjoying the period of exclusivity in a Chapter 11 case—a governance value even where there is no economic value.

Truth 4: Restructurings Are Costly for Creditors

The creditors of a distressed company are going to be ripped off by investment bankers, lawyers, and managements, whether the reorganization or liquidation process takes place out of court or in Chapter 11 or Chapter 7. Unlike common stock investing for control, when a company is distressed it is likely to pick up all the professional expenses for attorneys, accountants, investment bankers, and appraisers incurred by dominant creditors, whether the company is reorganized in Chapter 11 or out of court or it is liquidated under either Chapter 11 or Chapter 7.

Academic finance is way off base in attempting to measure the direct and indirect costs for a troubled company for professionals, particularly attorneys and investment bankers—the so-called direct costs of distress. In lead articles, including “Bankruptcy Resolution” by Lawrence A. Weiss (*Journal of Financial Economics* 27, 1990), it has been estimated that in Chapter 11 reorganizations direct costs average 3.1 percent of the book value of debt plus the market value of equity, with book value measured as of the end of the fiscal year before a filing for Chapter 11 relief. Two things are terribly wrong with this approach. First, as a percentage of asset value, asset value has to be measured, not as of the date before filing, but as of the date of confirmation of a POR. Such asset value would be either reorganization value or market prices immediately after confirmation. More important, though, is the failure of academics to realize that these professional fees and

expenses are administrative expenses, always paid in cash and always the beneficiary of a super-priority giving them precedence over prepetition debt. Thus, it is most meaningful to examine professional fees as a percentage of the cash in the distressed company at the time of reorganization.

Professional costs are highly burdensome in the reorganization of troubled issuers either in court or out of court. The debtor normally picks up the professional expenses of each creditor constituency, except the U.S. government. Those claiming these costs are not burdensome know not whereof they speak. The expenses are so large that it has become uneconomic to be involved in small Chapter 11 cases unless they are done pursuant to a prepackaged (or equivalent) plan.

In trying to measure the indirect costs of Chapter 11, it is important to add back its four benefits:

1. No requirement to pay interest to unsecured creditors during the pendency of a case, and probably not as part of a POR
2. The debtor better able to take advantage of benefits under the U.S. tax code if reorganized in Chapter 11 rather than out of court
3. The automatic stay during the pendency of a case
4. The availability of post-petition DIP financing, because post-petition lenders obtain super-priority as an administrative expense

Truth 5: Creditors Have Only Contractual Rights

A creditor has only contractual rights, not residual rights. Residual rights belong to owners (e.g., a duty of directors for fair dealing in relationships with owners). The law is well settled for solvent companies. The beneficiaries of duties of care and fair dealings by boards of directors and other control persons flow directly to the owners of firms. Lenders to solvent firms are entitled only to those rights that are spelled out in loan agreements and bond indentures, plus several other rights provided by law. Specifically, lenders obtain protection under statutes governing fraudulent conveyance and fraudulent transfers. But the lender to a solvent corporation has no residual rights (e.g., to be the beneficiaries of duties of care and fair dealing by the people running companies). These benefits belong to the business itself and specifically to business owners.

When a corporation enters into a zone of insolvency, most commentators agree that there tends to occur a shift in the duties of boards of directors from protecting the interests of owners to protecting the interests of creditors. This is somewhat vague since there is difficulty in defining exactly what a zone of insolvency is. When actually insolvent, the role of the board of directors shifts from protecting the interests of owners to protecting the interests of creditors.

REHABILITATION OF TROUBLED ENTITIES

There are three ways of rescuing troubled companies so that these companies have odds in their favor that they can be made feasible going forward.

1. Reorganize—that is, recapitalize:
 - a. Voluntary exchange offers
 - b. Small reorganization cases
 - c. Large reorganization cases

- d. Prepackaged, prenegotiated cases
- 2. Liquidate—that is, convert assets to other uses and/or other ownership and/or other control:
 - a. Section 363 sales
- 3. Make capital infusions into the business entity

Reorganizations

Whether the company being recapitalized is healthy or financially troubled, the techniques used to recapitalize have to be either voluntary or mandatory. Voluntary techniques (such as exchange offers) are those in which each security holder will make an independent decision whether to accept the offered recapitalization. If the security holder does not elect to accept the voluntary offer, there will be no change to the entitlements to cash interest and cash principal in accordance with the terms of the holder's credit instrument even if the required threshold of acceptances is met so that other terms of a credit instrument are altered. Mandatory techniques almost always entail use of the voting process and proxy machinery, which is almost always within the absolute control of management when a healthy company is involved but is rarely so when a troubled company is involved.

Voluntary Exchanges

Voluntary methods for the recapitalization of troubled companies are attempted prior to a Chapter 11 filing. These voluntary methods usually involve offers to current holders to trade their existing securities or debt instruments for new instruments, usually with a lower principal amount (typically set at a small premium over the current market) and with less onerous cash service requirements. Those making exchange offers often seek forbearance on defaulted cash service to creditors, hoping that no creditor group forecloses on collateral, accelerates the debt, or files an involuntary Chapter 11 or Chapter 7 petition under the bankruptcy code. Occasionally, there are offers to buy out creditors for cash, with the consideration representing a substantial discount from the face value of the claim but at a premium over the then current market value. For example, the Petro Lewis Corporation and First City Bancshares transactions involved cash offers to public bondholders.

The biggest problem with exchange offers is the voluntary aspect of the offer. No creditor can ever be forced to give up rights to cash interest or principal payments outside of a Chapter 11 case or a similar state proceeding. There is a large and growing list of companies that have experienced difficult and lengthy exchange offers or were totally unsuccessful in effecting recapitalizations through voluntary exchange offers.

The second-biggest problem with exchange offers is they require that a registration statement and prospectus be filed with the Securities and Exchange Commission (SEC) under the relatively onerous Securities Act of 1933. Such filings are often expensive and sometimes time consuming.

It is frequently difficult to induce voluntary exchanges when the debt instruments are publicly traded and the market prices of these credit instruments are substantially discounted from their principal amount.

Put simply, when there is a voluntary exchange, creditors know two things: (1) they cannot be forced to give up their contractual rights to money payments and (2) if they refuse to tender their security and then become holdouts, the chances are that the market value of the nontendered security will increase dramatically if other creditors accept the voluntary exchange offer and the troubled company elects to consummate the exchange, provided that the terms of the exchange offer do not result in considerable downside dangers for a non-exchanging creditor. This is true because without the downside threat, the creditworthiness of a non-exchanged instrument will be improved after the voluntary exchange is completed and the company's debt-service requirements are materially lessened. As a result, holders of public bonds are a different breed of animal from

holders of public stock when it comes to voluntary exchanges. Offer the latter a premium over market, and they may stampede to exchange. This is not so for creditors if the issuer cannot show the creditors meaningful risks if they do not exchange. It is also true that many of the holders of large positions in the debt of troubled companies are secondary market purchasers and not the original purchasers of the debt. Professional investors in troubled securities are much less likely to rush to accept voluntary exchange offers than are bondholders who acquired debt securities in order to collect interest income.

Issuers invariably attempt to coerce creditors in a voluntary exchange by seeking nonmonetary consents or amendments to the indentures or agreements under which the outstanding debt instruments were issued. These amendments or consents usually are structured so that non-exchanging creditors will have their collateral invaded or their seniority reduced if the exchange offer succeeds. Exchange offers were structured this way by the advisors to Public Service Company of New Hampshire prior to that company's filing for Chapter 11 relief. This attempt failed because sophisticated investors acquired a sufficient dollar amount of credit instruments so that the required amendments to the indentures to permit the company to invade collateral or reduce seniority could not succeed.

Seeking Relief under a Conventional Chapter 11 Filing

A Chapter 11 recapitalization has a distinct advantage over a voluntary recapitalization because of the mandatory nature of the recapitalization. In a Chapter 11, the reorganization is implemented and becomes binding on all claimants pursuant to a bankruptcy court order of confirmation. A court is entitled to confirm a plan of reorganization if two thirds in amount and a majority in number of holders of each separate class of claimants who voted on the plan (e.g., holders of secured debt and unsecured debt) elect to approve the plan and two thirds of the amount voted by party-in-interest holders (e.g., holders of preferred and common stock) elect to approve the plan. In addition, if some classes of claimants and interest holders approve the plan and other classes reject it, the bankruptcy court may confirm the plan over those rejections via a cram-down if the court determines that the plan does not discriminate unfairly, that it is fair and equitable to each class, and that the rejecting classes will receive more under the plan of reorganization than they would if the company were liquidated. There can be no cram-down of a rejecting class, however, if (1) the rejecting class will obtain less than the full value of its claims and (2) a more junior class will receive any value at all under the plan of reorganization.

Notwithstanding the merits of a Chapter 11 bankruptcy as a tool to restructure a troubled company, most troubled issuers and investment banks have considerable reluctance to use Chapter 11. The reluctance is premised on factors such as perceived stigma, large administrative expenses, and loss of management control. Although the stigma issue and the expense issue (at least versus voluntary exchanges) seem to have little basis in fact, control issues are very real considerations in uncontrolled Chapter 11 bankruptcies.

With respect to the stigma issue, there appears to be little difference for large troubled companies whether a reorganization takes place within or without a Chapter 11. Troubled companies are stigmatized (if at all) when they are not able to discharge debts on a timely basis, and that stigma will last only so long as the troubled financial condition exists. Whether the recapitalization takes place in Chapter 11 is a detail that is beside the point because the stigma, if any, already exists. Is there any company that has been successfully recapitalized—by way of either a bankruptcy or an exchange offer—and then suffered a continuing loss of goodwill? Today, people do not seem to perceive Chrysler, General Motors, CIT, and numerous smaller recapitalized companies as being stigmatized.

Ironically, an uncontrolled bankruptcy is often an expensive proposition for the debtor company. With court approval, the troubled company in Chapter 11 pays not only the fees and expenses of a whole host of professionals—attorneys, investment bankers, accountants, and sundry experts—who represent the company, but also the fees and expenses of various official creditors' committees, official equity committees, and such court-appointed officials as examiners. In addition, the debtor may be liable for the fees and expenses of others who have made "substantial contributions" to the reorganization of the company in Chapter 11. This heavy expense factor is offset to some extent by the existence of the automatic stay in bankruptcy that allows the company

to forgo cash service on prebankruptcy unsecured claims and certain secured obligations. The same type of heavy expenses, however, exist for out-of-court voluntary exchanges, usually without the full benefit of an automatic stay.

There is little doubt that an uncontrolled Chapter 11 case usually poses large threats to continued control of a business enterprise by its current management and stockholders. The loss-of-control issue, however, must be viewed in context. Even without seeking Chapter 11 relief, troubled companies most often are required, in connection with exchange offers and other voluntary attempts to recapitalize, to cede large blocks of control to creditors and others. Prior to a money default, most troubled companies have to act as supplicants in order to obtain relief from bank lenders, trade suppliers, labor unions, government agencies, and so on. After a Chapter 11 filing, though, it is common for lending institutions and trade creditors to be quite agreeable to providing post-petition financing to a debtor. Nonetheless, once a company has filed for Chapter 11, there is usually an additional and material loss of control during the pendency of the Chapter 11. The debtor company generally lays bare its business and financial soul; the company cannot take any actions outside its ordinary course of business without requisite notice followed by a hearing and approval by the bankruptcy court; the company must share business and strategic plans with claimants and major parties-in-interest; and the company subjects itself to massive reporting, discovery, and testimony under oath. In an uncontrolled Chapter 11, the odds are that claimants and parties-in-interest will be organized and knowledgeable, and their opposition to any proposals by the debtor company will be financed by the debtor company.

In an uncontrolled bankruptcy, there is also a risk that a trustee or examiner will be appointed to run, oversee, or investigate the affairs of the company. The trustee risk is remote if there is an absence of fraud or gross malfeasance. Examiners have duties that clearly impinge on managements' ability to run the business and the reorganization. For practical purposes, though, the appointment of an examiner remains an unlikely event.

A key element giving management a certain amount of control inside of Chapter 11 is that the debtor is granted the exclusive right to propose a plan of reorganization for up to a maximum of 18 months. During this period of exclusivity, the debtor is allowed an opportunity to negotiate with claimants and parties-in-interest to formulate a plan of reorganization. If a plan of reorganization is formulated, the debtor has an additional 60 days to solicit consents to its plan of reorganization. The period of exclusivity may not be extended beyond 18 months, and the exclusive right to solicit acceptances for a POR may not be extended beyond 20 months. Once the exclusive period is terminated, creditors can put forward their own plans that will likely result in a resolution of reorganization issues in a far different fashion from the one contemplated by management.

The ultimate loss of management control occurs if it is perceived that the Chapter 11 case is making no progress. Any claimant or party in interest may seek to either have the Chapter 11 dismissed or have the case converted to a Chapter 7 liquidation. If Chapter 11 is dismissed, the automatic stay is lifted and creditors are then entitled to move to assert their contractual remedies (i.e., foreclose on collateral and accelerate payments of debt). If the case is converted to a Chapter 7, a trustee is appointed, and the company is liquidated. Liquidation proceeds are paid out to claimants and parties-in-interest in accordance with a strict rule of absolute priority under which secured creditors have first priority to the extent of their collateral and common stockholders come last. For large public companies, however, the vast majority of Chapter 11 cases have resulted in plans of reorganization rather than a dismissal or a conversion of the case.

The ability to control the timing of events is a key element of management control. Timing is a difficult task to predict in a controlled Chapter 11 and impossible in an uncontrolled case.

Plans of reorganization also include corporate governance provisions as well as economic provisions. In most Chapter 11 cases, the corporate governance provisions adopted entrench existing management in office.

A conventional Chapter 11 has a number of tremendous advantages over a voluntary exchange. First, troubled companies are almost always troubled because they suffer from a cash shortage. Once a company files a petition for Chapter 11 relief, it can receive post-petition or debtor in possession (DIP) financing from financial institutions and trade creditors, which carries a super priority and will be repaid before prepetition debts. Thus, a company in Chapter 11 has access to financing that is usually unavailable to companies seeking to reorganize out of court. The automatic stay that goes into effect when Chapter 11 relief is put in place insulates managements

from continuous hounding by unpaid creditors, a common condition existing prior to any Chapter 11 filing. Furthermore, when a company emerges from Chapter 11, it is given a fresh start. Most claims against a company are resolved in the plan of reorganization, and most other claims not resolved are barred. By contrast, without court relief, a company is still stuck with all its old liabilities, known and unknown, contingent and fixed, in the financials or undisclosed anywhere. Hidden liabilities tend to be more of a real problem in analyzing troubled companies than is the case for healthy issuers.

Prepackaged or Preplanned Bankruptcy Reorganizations

Knowledgeable people in reorganizations go to great lengths to keep the reorganization process from getting out of control. This is not an easy thing to do when dealing with troubled companies, whether such companies seek to recapitalize voluntarily or seek Chapter 11 relief.

The events involving Public Service Company of New Hampshire are a good example of a needlessly uncontrolled bankruptcy. At the time of filing, Public Service had annual operating income before interest and taxes (EBIT) of around \$130 million that was derived from stable operations unrelated to its interest in the deeply troubled Seabrook nuclear facility. Clearly, Public Service was easily reorganizable, whether EBIT was \$100 million, \$200 million, or something in between, because a company can easily reorganize on the basis of existing earnings without extinguishing any security holders' ownership (existing holders of common stock would have had their percentage ownership reduced from 100 percent to around 2 to 5 percent of the reorganized entity). On January 28, 1988, however (and perhaps predictably), Public Service filed for bankruptcy relief without first attempting a prepack. The filing was precipitated by an adverse finding by the New Hampshire Supreme Court in a rate case. The filing resulted in an uncontrolled Chapter 11, and the scenarios outlined above for a hotly contested Chapter 11 reorganization were played out. In an analysis of Public Service, given its rate base, reorganization values ought to have ranged between \$800 million and \$1.2 billion in the absence of any rate increases. Since Public Service had outstanding only \$741 million of mortgage debt, it seemed obvious that all mortgage loans would be made whole, receiving in present value cash, new securities, or both cash and securities that would have a reorganization value equal to mortgage principal plus back interest. The mortgage bonds could have been purchased prior to and just after the Chapter 11 filing in the low 70s. The result for Public Service after a three-year case was a reorganization value of in excess of \$2 billion, which contrasted with the perceived maximum \$1.2 billion value prior to filing. The increase in value came about because the New Hampshire Public Utilities Commission allowed Public Service to benefit from massive rate increases. Put otherwise, the New Hampshire ratepayers were subjected to cost increases so that unsecured creditors could be made whole and holders of Public Service common stock could participate in the reorganization in a meaningful way.

Had Public Service been willing to consider a prepack, it might well have been able to reorganize within six months, with each class of security holders treated in a manner that complied with bankruptcy code requirements that the plan of reorganization must be fair and equitable to all parties. In addition, the plan could easily have been determined to be feasible (also as required by the bankruptcy code) because an agreement on retail rates could have been reached with the New Hampshire Public Utilities Service Commission in a less confrontational atmosphere than that which had existed prior to the Chapter 11 filing.

A prepackaged bankruptcy reorganization is provided for in Section 1126(b) of the bankruptcy code, which states, in part:

For purposes of subsection (c) and (d) of this section [(c) and (d) describe the requisite votes to approve a plan], a holder of a claim or interest that has accepted or rejected the plan before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be, if—

(1) the solicitation of such acceptance or rejection was in compliance with any *applicable non-bankruptcy law*, rule or regulation governing the adequacy of disclosure in connection with such solicitation

In other words, a troubled company whose securities are publicly traded can use the proxy

rules under Section 14 of the amended Securities and Exchange Act of 1934 to solicit consents of its creditors and equity holders to a Chapter 11 plan of reorganization before that company ever files for Chapter 11 relief. Again, in an uncontrolled Chapter 11, a troubled company is required to give seats at the negotiating and litigating table to all claimants and sometimes to parties-in-interest. In a prepack, the solicitation of acceptances of a plan of reorganization is conducted *before* creditors and equity holders are organized with official committees and aggressive attorneys and investment bankers, resulting in a much higher degree of management control. In essence, much of the infrastructure and massive cost of a bankruptcy currently provided for by the bankruptcy code can be avoided with a prepack. In addition, part of the beauty of a prepack is that the process deprives public bondholders of *any* incentive to hold out, because this is not a voluntary recapitalization technique.

As was already pointed out in Chapter 22 of this book, the control of the proxy machinery of a public company is virtually always within the power of management. In a prepack, the management of a troubled company controls the timing of the solicitation and the content of the solicitation materials. Clearly, management of a troubled company will find it much harder to obtain the prebankruptcy consents to the plan of reorganization than, for example, to obtain shareholder consent to elect a slate of directors. The prebankruptcy consents should be much easier to obtain, however, than those same consents after the various creditor groups are organized inside Chapter 11. Finally, if the prebankruptcy solicitation fails, the troubled company will always have the option to pursue a conventional Chapter 11. In such an event, the company will have the added momentum that will be provided by its attempted prepack.

Section 363 Sales

A 363 sale is the sale of assets by a company in bankruptcy in accordance with Section 363 of the Federal Bankruptcy Code. The process starts with a *stalking horse* bidder that enters into a purchase agreement for the assets. This provides a *floor bid* and serves as a basis for conducting an auction. As recognition of the expense and risk associated with entering into this agreement, the stalking horse bidder is entitled to a break-up fee and expense reimbursement if it is not the successful bidder. In conjunction with court approval of the stalking horse bid, dates are set for a bid deadline, auction, and court hearing to approve the winning bid. If other bidders submit *qualified bids* by the bid deadline, they are permitted to participate in the auction, which typically is conducted by the law firm representing the debtor. Following the auction, both the winning bid and an alternate bid are approved in a bankruptcy court hearing.

EXAMPLE

Third Avenue Value Fund purchased \$100 million (face) of Nortel Senior unsecured debt at an average price of 17 percent of claim following its bankruptcy filings in January 2009. The co-portfolio manager of the Fund, Ian Lapey, attended the auction of a portion of Nortel's Carrier Networks business (its Code Division Multiple Access and Long Term Evolution assets) on July 24, 2009, at the office of Cleary Gottlieb Steen and Hamilton LLP (Nortel's bankruptcy counsel). Nokia Siemens was the stalking horse bidder, a position that it earned by entering into a

purchase agreement on June 19th to buy the assets for \$650 million. The debtors (Nortel) determined that this agreement represented the best opportunity to maximize value for the assets and serve as a basis for conducting an auction. On June 29th and June 30th, respectively, the Canadian and U.S. bankruptcy courts approved Bidding Procedures, including a break-up fee of \$19.5 million and expense reimbursement of \$3 million if Nokia Siemens was not the successful bidder, and a July 21st deadline for competing bids. Additionally, a minimum overbid of \$5 million was established. Two additional parties, MPAM Wireless, Inc. (an affiliate of Matlin Patterson, a Nortel bond holder) and Ericsson submitted qualified bids prior to the deadline. These bids were required to exceed the stalking horse bid by the sum of the break-up fee, expense reimbursement, and minimum overbid. The auction on July 24th consisted of seven rounds of bidding with no bids received in the last round. Ericsson's sixth round bid of \$1.13 billion was the Successful Bid, and Nokia Siemens' \$1.03 billion fifth round was the Alternate Bid. Ericsson's bid represented a 70 percent improvement compared to the stalking horse bid, even adjusted for the payment of the break-up fee and expenses.

Section 363 sales can be preferable to corporate acquisitions for both buyers and sellers. Buyers benefit from asset purchases that are free and clear of all liabilities other than those that are expressly assumed (such as warranties). This simplifies the diligence process and enables buyers to avoid difficult-to-quantify liabilities such as retirement benefits and prepetition litigation. Additionally, valuations in 363 auctions are typically attractive, based primarily on asset value supported by tangible assets, such as real estate, receivables, and inventory, as opposed to going concern value.

Sellers benefit from a fair auction process in which price will usually be the sole factor in determining the winning bidder. This typically is not the case in corporate deals when management often drives the process to their benefit.

EXAMPLE

Instinet's management and a private equity investor purchased the company's agency brokerage business

for \$207 million, a discount of \$100 million from what the Third Avenue Value Fund offered, and sold the business one year later to Nomura for \$1.2 billion.

Companies such as GM and Chrysler that were burning significant cash from operations before debt service (not the case with Fleetwood or Nortel) may not experience a fair auction process, particularly if existing creditors are unwilling to fund additional losses. In these situations, the field of bidders is limited (only the U.S. Government in the case of GM and Chrysler) and liquidation can be the only alternative to a fire sale.

Capital Infusions

Making capital infusions into troubled issuers was a wonderful business in 2008–2009. Those making capital infusions can almost write their own tickets. And it is much more productive for troubled companies to have investors, private or governmental, buy new securities directly from the company rather than from existing shareholders.

A few examples of capital infusions are as follows:

- JPMorgan Chase acquired Bear Stearns by issuing common stock and delivering to Bear Stearns creditworthiness.
- Wells Fargo acquired Wachovia Bank at a huge discount from net asset values.
- The federal government acquired controlling interests in Fannie Mae, Freddie Mac, and AIG by receiving in exchange for cash infusions units of preferred stock and warrants to acquire majority interests in the troubled companies.
- Berkshire Hathaway, in return for cash infusions, received units of preferred stock and common stock issued by Goldman Sachs and General Electric.
- The U.S. government invested \$700 billion into troubled financial institutions through the Troubled Asset Relief Program (TARP), presumably by purchasing units consisting of perpetual preferred stocks and warrants to buy common stock. The perpetual preferred stocks paid dividends of 5 percent (9 percent after five years), were callable, were transferable, and had limited voting rights. The perpetual preferreds, in other words, were plain vanilla. The warrants to purchase common stock permitted the owner(s) of the warrants to purchase a number of common shares with an aggregate price equal to 15 percent of the amount of investment in the perpetual preferred stock. The warrants were exercisable at a price equal to the average trading price for the 20-day period prior to the initial issue of the perpetual preferred stock.²

All of these capital infusions with equity components resulted in highly dilutive results for existing stockholders unless such infusions were made pursuant to rights offerings to existing shareholders. Rights offerings are relatively rare. Where undertaken, existing shareholders are given transferable rights permitting them to subscribe to the new issue on a pro-rata basis, usually with an oversubscription privilege. Rights offerings are normally open for a 21-day period. Existing stockholders do benefit from capital infusions even when they are subject to massive dilution, which is the usual case where there is no right offering, because the companies in which they have invested are credit enhanced, usually very materially credit enhanced.

SUMMARY

Distress investing involves being a special sort of creditor. Most credit analysis revolves around trying to predict whether there will be a money default. In distress investing we assume that a money default is likely to occur. Distress investment analysis bottoms on figuring out what happens next; that is, after a money default occurs. We explain the five basic truths that guide all reorganizations of troubled issuers. There are three ways of rescuing troubled companies so that these companies have odds in their favor that they can be made feasible going forward. These methods are: (1) reorganize—that is, recapitalize, through either voluntary exchanges, standard reorganizations, and prenegotiated cases; (2) liquidate—that is, convert assets to other uses and/or other ownership and/or other control; and (3) make capital infusions into the business entity.

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¹ We have discussed the issues of substantive consolidation in Chapter 3, defined the concept of the OPMI in Chapter 1, and thoroughly contrasted our investing approach to academic finance in Chapter 17.

² We discuss the role of government in reorganizations in Chapter 24 of this book.

CHAPTER 24

The Role of Government in Reorganizations*

Bailouts or Capital Infusions?

Too Big to Fail Is a Phony Concept

The Government and Private Sector Are in Partnership Whether They Like It or Not

Wall Street Professionals and Corporate Executives Are All in the Business of Creating Moral Hazards

Taxpayer Bailouts Are a Phony Concept

A Revolution in Corporate Reorganizations and Liquidations May Have Occurred in 2009 with the Chapter 11 Reorganizations of General Motors, Chrysler, and CIT Corporation

Strict Regulation of Financial Institutions Is Absolutely Necessary

Summary

As we have already pointed out in the previous chapter, there are three ways of rescuing troubled companies so that these companies have odds in their favor that they can be made feasible going forward.

1. Reorganize—that is, recapitalize
2. Liquidate—that is, convert assets to other uses and/or other ownership and/or other control
3. Make capital infusions into the business entity

Sometimes capital infusions are made by the private sector. Sometimes governments have to make the capital infusions because no funds are available from the private sector. This occurs at the all-too-frequent times when private markets freeze up because these markets, for these purposes, are notoriously capricious and grossly inefficient. All sorts of businesses, especially most financial institutions, need continuous access to capital markets. Capital infusions are their lifeblood. Sometimes the infusions have to be supplied by governments.

BAILOUTS OR CAPITAL INFUSIONS?

To economists, capital infusions by governments are known pejoratively as *bailouts*. It isn't necessarily so. It certainly isn't so if the government earns a reasonable profit from the capital

infusion and/or otherwise obtains productive concessions from the entities that receive the capital infusion. To distinguish between a bailout and a capital infusion, a bailout exists where a capital infusion is made into an economic entity with no prospect of any return whatsoever. If a return is expected, however measured, it is a capital infusion.

In many recent cases—Lehman Brothers, AIG, Citigroup, Fannie Mae, Freddie Mac—it would have been extremely difficult, if not impossible, to either reorganize or partially liquidate each company in order to rehabilitate it. This was the case whether the rehabilitation would have taken place through voluntary exchanges or by seeking court protection, usually under Chapter 11. First, voluntary exchanges frequently don't work since, as we have already pointed out in the previous chapter, in the United States no creditor can be compelled to give up a right to a money payment unless the individual creditor so consents, or a court of competent jurisdiction, a Chapter 11 Court, imposes an automatic stay on payments. Seeking Chapter 11 relief (or its rough equivalent from a State Insurance Department), might not contribute to an effective rehabilitation since many assets of troubled issuers, such as derivatives, don't deliver to the troubled issuer the benefits of the automatic stay. Thus, as if almost by default, the preferred method for rehabilitating troubled financial institutions in 2008–2009 was making capital infusions by the government and government agencies.

The basic problem with the various government stimulus packages certainly has nothing to do with the taxpayer bailouts or whether or not the returns to the government agencies from providing the financing result in an accounting profit. Rather, the problems revolve around *quid pro quos*. There was an apparent failure of the government to negotiate terms for the capital infusions, which might have compelled various financial institutions in return for the government's capital infusions, to undertake actions, which would have been beneficial to the economy even though they entailed realizing losses for the financial institutions.

EXAMPLE

One *quid pro quo* could have been the required restructuring of large amounts of underwater residential mortgages held as assets by the financial institution receiving the capital infusion. Another *quid pro quo* might have revolved around counterparty risk inherent in derivatives, such as Goldman Sachs, under the threat of AIG insurance subsidiaries entering state-supervised conservatorship, might have been coerced into compromising its claims as a policyholder of credit default swaps.

Admittedly such strong-arm tactics probably were politically unfeasible. However, we bet that if it were private, profit-seeking entities negotiating the terms for capital infusions into troubled companies, lots of strong-arm compulsion would have existed. *Quid pro quos* would have occurred.

TOO BIG TO FAIL IS A PHONY CONCEPT

Bank holding companies and commercial banks are two different financial institutions. Bank Holding Companies own the common stocks of commercial banks, frequently the common stocks of other eligible businesses and perhaps other assets. Bank holding companies are financed conventionally—perhaps with several layers of debt, mostly publicly held preferred stocks and publicly owned common stock.

Commercial banks are primarily financed by deposits plus, to a much smaller extent, loans from U.S. government agencies.

Failure of a financial institution occurs when the holding company's common stockholders are wiped out, or almost completely wiped out, whether that holding company is a bank holding company, an insurance holding company, a broker-dealer holding company or another type of holding company. Thus, in 2008 and 2009 many giant financial institutions did, in fact, fail. Such failures included AIG, Citigroup, Lehman Brothers, Fannie Mae, Freddie Mac, Bear Stearns, GMAC, and Countrywide Financial. With the possible exception of Lehman Brothers, all of the above-named failed companies are still in business.

Those inexperienced in rehabilitating companies don't really mean Too Big to Fail. They mean:

Too Big to Be Reorganized or Liquidated in an Uncontrolled, Contested Proceeding Whether Out-of-Court or in Chapter 11.

The solution to preventing Lehman-type debacles seems to be not to restrict the size of financial institutions, but rather to set in place mechanisms whereby financial institutions—large and small—can be reorganized, if troubled, via prepackaged, prenegotiated plans of reorganizations (POR) where relevant government regulators have a strong influence on what the POR will be. The reorganization of General Motors, Chrysler, and CIT, all accomplished after less than 60 days in court, may have set a very good precedent for where major U.S. reorganizations ought to go.

In other countries, the existence of giant financial institutions doesn't seem to cause a problem. Canadian finance seems to function extremely well, dominated by five super-large commercial bank holding companies.

Most financial institutions need relatively continuous access to capital markets to refinance short-term indebtedness of all sorts. As such, even well managed companies can be in trouble when markets freeze up as they did in 2008. Mechanisms ought to be in place to provide capital, and/or expeditiously reorganize these companies, which are reasonably well managed but lack access to capital markets. Badly managed companies ought to be permitted to be sick—that is, go out of business either through liquidation or the reorganization process. This is the case regardless of the size of the enterprise. The thing that ought to be avoided in the United States at any rate is uncontrolled reorganizations and liquidations; these are inordinately expensive and inordinately unpredictable. Very little will be accomplished, we fear, without intelligent courts, and intelligent, powerful regulators.

THE GOVERNMENT AND PRIVATE SECTOR ARE IN PARTNERSHIP WHETHER THEY LIKE IT OR NOT

The real environment that exists is that the government is part of the problem and part of the

solution. The private sector is also part of the problem and the solution. If you don't believe that the private sector is part of the problem, look at the ultrapoor performance of various parts of the private sector in the last thirty years ranging from the 2008–2009 fiasco in residential housing and going through the myriad of failed companies in automobile manufacturing, textiles, shoes, TV set manufacturing, steel, motion picture exhibition, real estate, and retailing, among others.

It is important for the government to provide meaningful incentives to the private sector, and, in general, the government should earn reasonable returns for providing such incentives. There are myriad relationships between the private sector and the government. There are three areas, though, where the private sector reacts instantly, massively, and efficiently to government policies. It is as if government policies, in reality, direct the invisible hands that Adam Smith wrote about in 1776. These three areas are tax policy, credit granting, and credit enhancement.

In terms of tax policy, much more important than the tax rate are tax provisions that give the private sector incentives to undertake activities that might be highly productive. For example, there seems to be a crying need for the private sector (rather than the government) to be making equity investments in financially troubled companies. Corporations such as AIG, General Motors, Chrysler, and Citigroup, all have hidden assets, in the form of billions of dollars of unused tax loss carryforwards. It would be highly productive if Section 382 of the Internal Revenue Code (IRC) were repealed or amended to eliminate the change of ownership rules in order to ensure that these tax loss carryforwards would be available to offset future income taxes that would otherwise be payable by such companies. Under Section 382, the issuance of a significant amount of new stock by a troubled company could result in a change of ownership, which could dramatically reduce the ability of the issuing company to use its tax loss carryforwards. The change of ownership rules deter financially troubled companies from issuing significant equity, which could provide much needed capital for use in expanding their existing businesses or in acquiring new and potentially highly profitable businesses. Under present law, it is pretty much impossible for a troubled company to issue significant amounts of new shares of its common stock without sacrificing the ability to use its net operating loss carryforwards.

Tax loss carryforwards become a tremendously valuable asset for troubled companies insofar as:

- Future losses are stemmed or eliminated.
- New sources of income can be sheltered from taxation.

The repeal of the ownership change rules would encourage the country's leading entrepreneurs, investors, and investment bankers to make massive equity infusions into troubled companies. Furthermore, equity capital would improve the issuers' balance sheet, but fear of triggering an ownership change drives companies to borrow, which overextends them.

The virtual ban on the trafficking in tax losses is a relatively new phenomenon. The current version of Section 382 was promulgated as part of the Income Tax Reform Act of 1986. In our opinion, it is likely that increases in productivity from the repeal of Section 382 would far outweigh the losses of tax revenue for the government.

WALL STREET PROFESSIONALS AND CORPORATE EXECUTIVES ARE ALL IN THE BUSINESS OF CREATING MORAL HAZARDS

The environment for moral hazard exists where an activist can create a situation *vis-à-vis* a passivist, so that the activist can believe "Heads I Win; Tails I Don't Lose or I Don't Lose Too Much." That's what corporate executives do *vis-à-vis* their stockholders. That's what Wall Street

professionals do as underwriters, salesman, investment bankers, hedge fund general partners, leverage buyout general partners and mutual fund managers.

Economists seem to believe that much of the problem in commercial banking revolves around moral hazard—banks financed largely with government insured deposits could take special risks in lending because if the loans turned bad, the government would bail out the depositors. Virtually all these commercial banks were, and are, wholly owned subsidiaries of holding companies. Insofar as the banks took excessive risk, holding company security holders were compromised, or in many cases virtually wiped out (see Citigroup Common). Prior to 2008–2009, bank management caused the banks to take risks for which they were not close to adequately compensated. The blame for these management shortcomings seems not to be on moral hazard, but rather incompetence and a follow-the-herd mentality.

We are troubled by all these moral hazard attacks. First, we've never met a bank executive who did not care very much about the interests of the holders of holding company common stock. Second, and more important, if moral hazard were eliminated, we fear the economy would be much less innovative and productive than it is.

TAXPAYER BAILOUTS ARE A PHONY CONCEPT

In Chapter 11 proceedings, there are questions of substantive consolidation, for instance, should a parent company and its subsidiaries be treated as one entity for reorganization or liquidation purposes, or should they be treated as separate entities. The government is the government; it is not the taxpayers unless one stretches the concept of substantive consolidation beyond reason. If the government provides financing to the private sector on a basis where there are positive returns to the government or the country, there has been no bailout. If the government provides financing to private sector entities at a loss to the government or the country, then it is the government providing bailout funds, not taxpayers who can be deemed to be the equivalent of common stockholders. In the first instance, the funds for the “bailout” are provided to the government by lenders to the government, such as the Chinese much more than average taxpayers.

The concept of taxpayer bailout seems to be a pejorative uttered by sincere people who do not understand that capital infusions can be an extremely useful tool, but only one tool, useful in the rehabilitation of financially troubled entities.

A REVOLUTION IN CORPORATE REORGANIZATIONS AND LIQUIDATIONS MAY HAVE OCCURRED IN 2009 WITH THE CHAPTER 11 REORGANIZATIONS OF GENERAL MOTORS, CHRYSLER, AND CIT

CORPORATION

We are the authors of, *Distress Investing—Principles and Technique* (John Wiley & Sons, 2009). We finished writing the book in December 2008. At that time, we never dreamed that if a major corporation like General Motors filed for Chapter 11 relief that anything could be done in the short term. Rather, we thought it had to be an uncontrolled proceeding full of uncertainties, with an unpredictable outcome, lengthy and very, very expensive with administrative costs probably running to several billion dollars. In our book we pointed out how important it was to have controlled reorganizations or liquidations: prepacks, prearranged, or whatever. At the time, we wrote that controlled reorganizations appeared doable only for small companies.

Perhaps General Motors, Chrysler, and CIT have set a new precedent that will give rise to new legislation that will permit, and even encourage, all sorts of troubled issuers to reorganize expeditiously in a controlled manner while still preserving creditor rights. If so, such developments would be highly constructive for the U.S. economy.

STRICT REGULATION OF FINANCIAL INSTITUTIONS IS ABSOLUTELY NECESSARY

The enormous success of the mutual fund industry over the last twenty-five years seems directly attributable to ultrastrict regulation under the Investment Company Act of 1940 as amended (the Act). Because of the strictness of the Act, investors woke up to the fact that the industry could be trusted; fund investors would get a fair shake. There is no question that the existence of the Act has stifled initiative, is very expensive, is sometimes unfair and places burdens on a fund manager, such as ourselves, that we'd rather not have. Granting this, we have no question that the existence of the Act has been beneficial to the Industry.

In seeking strict regulation for other financial institutions, legislation might well look at the Act as a template for regulation, adapting the principles of the Act to the regulations of other financial institutions all of whom are vastly different from mutual funds and need vastly different regulations. Comprehensive regulation should cover the various areas covered by the Act: asset composition; how financed; how operations are conducted; executive compensation; corporate governance; disclosure requirements; and income tax issues.

SUMMARY

Making capital infusions into troubled companies is one of the three methods available to rescue these entities so that they have odds in their favor that they can be made feasible going forward. Sometimes capital infusions are made by the private sector. Sometimes governments have to make the capital infusions because no funds are available from the private sector. This occurs at the all-too-frequent times when private markets freeze up because these markets, for these purposes, are notoriously capricious and grossly inefficient. All sorts of businesses, especially most financial institutions, need continuous access to capital markets. Capital infusions are their lifeblood. Sometimes the infusions have to be supplied by governments. The concepts of taxpayer bailouts and too big to fail are phony concepts, and we explain why. The government and the private sector are in partnership whether they like it or not. A revolution in corporate reorganizations occurred with the reorganizations of GM and Chrysler. It is clear to us that strict regulation of

financial institutions is necessary.

* This chapter contains original content and parts of the chapter are based on ideas contained in the 2005 4Q letter to shareholders.

Part Five

Active Investors Buy and Sell Common Stocks
on an Advantageous Basis

CHAPTER 25

The Economics of Private Equity Leveraged Buyouts

The 2005 Acquisition of Hertz Global Holdings and Subsequent Events as a Prime Example

Super-Attractive Access to Capital Markets

Cash Payments to Sponsors and Sponsor-Controlled Funds

Sponsors' Control of Hertz

Sponsors Attuned to the Needs of Bankers and the Wall Street Underwriting Community

Questions about LBOs

Summary

This chapter discusses the 2005 leveraged buyout (LBO) of the common stock of Hertz Global Holdings at a relatively high price earnings (P/E) ratio and a substantial premium above book value. Despite mediocre operating results subsequent to the LBO, the Hertz Global Holdings transaction seems to have been quite remunerative for the LBO sponsors and their investors. In our view this success is attributable mostly to the fact that time and again the sponsors enabled holders of Hertz Global Holdings common stock to obtain super-attractive access to capital markets. Also sponsors and investors received two large dividends where the funds for paying one of the dividends came from a loan with liberal covenants, and for the other, from the proceeds of an underwritten common stock offering to the public.

THE 2005 ACQUISITION OF HERTZ GLOBAL HOLDINGS AND SUBSEQUENT EVENTS AS A PRIME EXAMPLE

The essential element of any LBO is the purchase of 100 percent of the outstanding common stock of the target company, almost always for cash, thereby eliminating the interests in the company of the selling stockholder(s). In December 2005 Ford Motor Company, the sole stockholder of a company since renamed Hertz Global Holdings (Hertz), sold its entire interest in the common stock of Hertz for approximately \$2,295,000,000 cash. The private equity group purchasing Hertz

consisted of a consortium, or club, put together by three sponsors (sponsors): Clayton Dubilier and Rice (CDR); Carlyle Group (Carlyle); and ML Global Private Equity Fund (Merrill Lynch).

From the point of view of the sponsors, and the sponsors' investors, the Hertz buyout has proved to be highly successful despite the fact that from 2006 through June 30, 2012, Hertz has been a quite mediocre operation reporting losses under Generally Accepted Accounting Principles (GAAP) in three of the six years from 2006 through 2011. From 2006 to date, the sponsors on behalf of themselves and the investment funds managed by them have extracted \$4,973,500,000 in cash either from Hertz or from sales of Hertz common stock in public offerings. At the time of this writing, the investment funds still hold 110,009,479 shares of Hertz common with a market value of almost \$1,800,000,000.

SUPER-ATTRACTIVE ACCESS TO CAPITAL MARKETS

Clearly, the principal contributing factor to the success of the sponsors and their investors has been the sponsor's enormous ability and enormous credibility in accessing capital markets on a super-attractive basis. This has enabled Hertz time and again to finance cash payouts to investment funds managed by the sponsors. This ability to access capital markets on an attractive basis seems pervasive in the LBO industry for not only CDR, Carlyle, and Merrill Lynch, but also for a number of other sponsors.

The goal of the Hertz sponsors seems two-pronged:

- First maximize sponsors' and their controlled investment funds net present values (NPV) by extracting from Hertz and the public markets for the benefit of the sponsors and investment funds as much cash as possible as soon as possible.
- Second, keep control of Hertz and extract large amounts of fees and emoluments from Hertz, probably largely or completely for the benefit of the sponsors and their appointed Hertz directors.

[Table 25.1](#) summarizes the Hertz income accounts for the periods from calendar 2006 through June 30, 2012.

[Table 25.1](#) Hertz Global Holdings Income Statement (000)

For the Fiscal Period Ending 12/31	6 months, June 30							
	2006	2007	2008	2009	2010	2011	2011	2012
Revenues								
Car Rental	\$6,273.6	\$6,800.7	\$ 6,730.4	\$5,872.9	\$6,355.2	\$6,929.6	\$ 3,210.1	\$ 3,472.6
Equipment Rentals	1,672.1	1,755.3	1,657.3	1,110.2	1,069.8	1,208.8	569.7	635.5
Others	112.7	129.6	137.4	118.4	137.5	160.0	72.4	78.0
Total Revenues	8,058.4	8,685.6	8,525.1	7,101.5	7,562.5	8,298.4	3852.3	4186.1
Expenses								
Direct Operating	4,476.0	4,644.1	4,935.3	4,086.8	4,283.4	4,566.4	2,261.0	2,304.1
Depreciation of Revenue Earning Equipment and Lease Charges	1,757.2	2,003.4	2,196.9	1,933.8	1,868.1	1,905.7	855.8	1,033.9
Selling, General, and Administrative	723.9	775.9	768.8	641.9	664.5	745.3	377.8	414.3
Interest Expense Net	900.7	875.4	845.2	664.3	761.1	694.2	359.3	312.9
Other (Income)/Expense-Net	—	—	—	(48.5)	0.0	62.5	62.7	(1.0)
Impairment Charges	—	—	1,195.0	—	—	—	—	—
Total Expenses	7,857.8	8,298.8	9,941.2	7,278.4	7,577.2	7,974.1	3,916.5	4,064.2
Income (loss) before Income Taxes	200.6	386.8	(1,416.1)	(176.9)	(14.6)	324.3	(64.2)	121.9
(Provision) Benefit for Income Taxes	(68.0)	(102.6)	248.3	62.0	(16.7)	(128.5)	(4.6)	(85.4)
Net Income (Loss)	132.6	284.2	(1,167.8)	(114.8)	(31.3)	195.7	(68.8)	36.5
Non-Controlling Interest (After Tax)	(16.7)	(19.7)	(20.8)	(14.7)	(17.4)	(19.6)	(8.8)	—
Income Attributable to Common Stockholders	115.9	264.5	(1,188.6)	(129.5)	(48.7)	176.2	(77.6)	36.5
Earnings per Share								
Basic	0.48	0.80	(3.68)	(0.35)	(0.12)	0.42	(0.19)	0.09
Diluted	0.48	0.79	(3.68)	(0.35)	(0.12)	0.40	(0.19)	0.08

In marketing a \$1,950,000,000 unsecured loan in 2012, Hertz mostly ignored GAAP income attributable to common stockholders, but instead focused on corporate earnings before interest, income taxes, depreciation, and amortization (EBITDA). EBITDA do not seem to be figures with much economic significance for potential unsecured creditors, simply because in Hertz's case the bulk of depreciation charges do not appear to be noncash charges. Rather Hertz is required to replace its revenue-generating equipment continuously; cars become obsolete within relatively short time periods and industrial equipment ages with use. Table 25.2 shows that depreciation of revenue earnings equipment plus proceeds from the disposal of revenue equipment barely exceeded revenue earnings equipment expenditures for the six years and six months ended June 30, 2012. The excess of depreciation of revenue earnings Equipment plus proceeds from the sale of such equipment exceeded capital expenditures by only \$1 billion over the six-and-a-half-year period.

Table 25.2 Selected Consolidated Cash Flows, Hertz Global Holdings, Inc.

For the Fiscal Period Ending 12/31	2006	2007	2008	2009	2010	2011	6 Months, June 30	
							2011	2012
Depreciation of Revenue-Earning Equipment	\$1,757.2	\$ 2,003.4	\$ 2,085.7	\$1,852.1	\$1,789.9	\$1,809.6	\$809.4	\$989.3
Proceeds from Disposal of Revenue-Earning Equipment	9,555.0	9,321.8	8,619.7	6,106.6	7,518.4	7,850.4	3,488.9	3,608.3
Total	11,312.2	11,325.2	10,705.4	7,958.8	9,308.3	9,660.1	4,298.3	4,597.6
Revenue-Earning Equipment Expenditures	(11,420.9)	(11,157.8)	(10,151.0)	(7,527.3)	(8,440.9)	(9,454.3)	(5,466.9)	(5,698.9)
Cash Generated (Consumed)	(108.7)	167.4	554.4	431.4	867.5	205.7	(1,168.6)	(1,101.3)
Net Income (Loss) as Reported per GAAP	115.9	284.2	(1,186.0)	(114.8)	(31.3)	195.7	253.8	36.6

In contrast, Hertz focuses on corporate EBITDA for the six years and six months in marketing unsecured debt in 2012 as shown in [Table 25.3](#).

Table 25.3 EBITDA for Hertz Global Holdings, Inc. (000)

Year	2006	2007	2008	2009	2010	2011	6 Months 2012
Corporate EBITDA	\$1,379	\$1,542	\$1,100	\$980	\$1,100	\$1,390	\$1,477

Despite these mediocre operating results, Hertz was able to borrow \$1,950,000,000 to fund the \$2,200,000,000 acquisition of Dollar Thrifty Group (DTG) which closed on November 16, 2012. Such borrowing is on an unsecured basis where a one-year bridge loan may convert into an unsecured eight-year bullet (i.e., nonamortizing) loan. In our view, the Sponsors and Hertz management deserve great plaudits for their ability to consummate such a financing, even at interest rates, which could reach $57\frac{7}{8}$ percent plus fees. This seems to be an excellent example of the sponsors' credibility and talent for accessing capital markets on a super-attractive basis. If we were the lenders, and given Hertz's record in the last six and one half years, there is no question that we would lend for the DTG transaction at a price near the principal amount only if we believed we were adequately secured.

The ability to market unsecured debt reflects super-attractive access to capital markets. While the acquisition of DTG may make Hertz's future much brighter than would be the case where the analyst relied heavily on Hertz's operating record from 2006 to 2012, this ought not to be much of a consideration for unsecured creditors acquiring debt instruments priced at or near the principal amount, which in this case is equal to the call price. The unsecured credit instrument has no material price upside potential, and the holder has to be convinced the loan will be a performing loan. In that environment a potential creditor would not rely on outlooks based on a base case analysis or an optimistic analysis. Rather the creditor should reach his conclusions based on a reasonable worst-case analysis. Given Hertz's six-and-one-half year record, it seems quite risky to pay the principal amount to become an unsecured creditor of Hertz based on any reasonable worst-case analysis. Indeed, it appears as if there might have been a question about Hertz's ability to remain solvent after the economic meltdown occurred in late 2008 and early 2009. An unsecured creditor using a reasonable worst-case analysis probably would conclude that economic conditions could at some indeterminate time in the future again approximate the 2008–2009 economic meltdown in either North America or Europe or both.

CASH PAYMENTS TO SPONSORS AND SPONSOR-CONTROLLED FUNDS

The ultraskillful use by the sponsors of capital markets is demonstrated in [Table 25.4](#), which summarizes cash payments to sponsors and sponsors-controlled investment funds from 2006

through December 2012.

Table 25.4 Cash Payments to Sponsors and Controlled Investment Funds (000)

Approximate Date	Amount Paid (Spent)	Source of Cash	Per Share Public Offering Price for Sale of Shares
Jun-06	\$991,000	Dividend (a)	
Nov-06	\$1,297,000	Proceeds from IPO	15.00
Nov-06	\$257,000	Dividend	
Pre Nov-06	\$75,000	Consulting fee	
During 06	\$3,000	Ongoing consulting fee	
Nov-06	\$15,000	Termination of ongoing consulting fee	
Jun-07	\$966,000	Sale of common stock to public	22.25
May-09	(\$200,000)	Purchase of newly issued common stock	(6.23)
Mar-11	\$781,000	Sale of common stock to public	15.63
Dec-12	\$788,500	Sale of common stock to public	15.77
TOTAL	\$4,973,500		

(a) The funds to pay the dividend came from a loan facility with Deutsche Bank, Lehman Commercial Paper, Inc., Merrill Lynch Capital Corporation, Goldman Sachs Credit Partners, LP, JPMorgan Chase Bank, and Morgan Stanley Senior Fund. The loan facility resulted in a loan to Hertz of \$1,000,000,000 with the use of proceeds earmarked to pay a dividend to Hertz shareholders. Hertz was required to pay interest in cash, but only to the extent that funds were available by way of dividend from an operating subsidiary. Insofar as interest was not paid in cash the credit instruments was to become a zero coupon instrument. The loan was repaid with the proceeds of the November 2006 Initial Public Offerings (IPO) of Hertz common stock. The loan bore interest at about an 8.6% rate.

The \$1,000,000,000 loan provides strong evidence of the sponsors' ability to access credit markets on super-attractive terms. The lenders were a blue chip group of financial institutions and the terms—especially the possible deferral of cash interest payments—was quite attractive for Hertz. Such borrowing capacity does not seem achievable by almost any individual outside passive minority investor (OPMI) or group of OPMIs.

After extracting nearly \$5 billion from Hertz and the public market, investment funds associated with CDR, Carlyle, and Merrill Lynch still owned about 26 percent of the outstanding common stock capitalization. At a price of 16.24 at the time of this writing, the market value of the Hertz shares held by the investment funds was over \$1.8 billion.

We have not seen any of the private placement memorandums (PPMs) of the various investment funds. Therefore we do not know the terms of the relationships between the sponsors (i.e., general partners [GPs]), and the investors (i.e., limited partners or LPs or OPMIs). However, even assuming a high level of compensation to the GPs—say a 2 percent management fee plus a 20 percent profit carry plus all fees paid by Hertz going to the GP, Hertz seems to have been a super-attractive deal for the LPs. This super-attractiveness does not seem to trace to any achievements by Hertz as an operation in the last six and a half years. Rather it seems attributable to the talents evidenced by the GPs in accessing capital markets. This skill is not exclusive to CDR, Carlyle, or Merrill Lynch. We think it exists for among others, Brookfield Asset Management Private Partnerships, Vestar, and Leonard Green.

SPONSORS CONTROL OF HERTZ

The sponsors are in firm control of Hertz even though a majority of the Hertz board of directors have been “independent directors” since August 2011. CDR has two seats on the board, one of whom is chairman, and Carlyle and Merrill Lynch each have one seat. Directors now receive annual retainers of \$210,000 of which \$85,000 is paid in cash and \$125,000 in equity. Additional cash compensation of \$25,000 is paid to the chairman of the audit committee and other members of the audit committee receive \$10,000. For service on the compensation, nomination and governance committee the chairman received \$15,000 and other members \$10,000. In addition after serving for 5 years, a director receives, among other things, free worldwide rentals for 15 years thereafter.

Other benefits accruing to the sponsors and investment funds include demand rights of registration for the sale of Hertz common stock and indemnification agreements. The reputation of the sponsors is probably a principal reason why Hertz common enjoys such a good aftermarket on the New York Stock Exchange most of the time despite the mediocre performance of the Hertz business since 2006. The really poor price performance of Hertz common occurred during the 2008–2009 economic meltdown. Otherwise Hertz common seems to be selling most of the time at very high P/E ratios and large premiums over book value. [Table 25.5](#) summarizes the price history of Hertz common.

Table 25.5 Hertz Global Holdings Common Stock Price

Year Ended 12/31	High	Low
2006	\$17.48	\$14.55
2007	\$27.20	\$14.81
2008	\$15.85	\$1.55
2009	\$12.55	\$1.97
2010	\$15.60	\$8.36
2011	\$17.64	\$7.80
2012	\$16.50	\$10.62

SPONSORS ATTUNED TO THE NEEDS OF BANKERS AND THE WALL STREET UNDERWRITING COMMUNITY

It seems to us that the sponsors are sensitive to the needs of bankers and the Wall Street underwriting community. In particular the gross spreads paid to underwriters seem reasonable, and as far as we know the sponsors try to price public offerings so that aftermarket prices will be buoyant, better than the underwriting price. This is in contrast with seemingly unsophisticated issuers, such as Facebook, Inc. who negotiated for minimum gross spreads and tried to price issues at peak prices while selling as many shares as is feasible in an IPO. A comparison of gross spreads is shown in [Table 25.6](#).

Table 25.6 Underwriting Gross Spreads

Issuer and Date	Gross Spread
-----------------	--------------

Hertz 11/06	4.25%
Hertz 6/07	3.50%
Hertz 5/09	4.14%
Facebook 5/12	1.10%

The aggregate size for the Facebook offering was far greater than any Hertz offering so that the aggregate dollars of gross spread for Facebook of some \$176 million dwarfed the comparable number for Hertz. Yet it seems likely that Facebook was a lot less sensitive to the needs and desires of the underwriting community than were the Hertz Sponsors.

QUESTIONS ABOUT LBOS

Finally, there are three questions that arise in examining LBOs that follow the Hertz pattern, as we believe most of them do:

1. Do LBOs help the target company?
2. Do LBOs help the general economy?
3. Are LBOs attractive investments for OPIMs who become limited partners?

Given LBO sponsors' predilection toward maximizing net present values for themselves and their LPs it would appear as if the LBO phenomenon contributes little, or nothing, to either growing a target company or making it more creditworthy. In fact, much of what the sponsors demand can be negative for the target company. This is sometimes ameliorated. When Hertz was in deep trouble in 2009, a capital infusion in the form of common stock by the investment funds and the public may have been crucial in having Hertz avoid a painful restructuring, perhaps in Chapter 11.

From a financial point of view it is hard to see how LBOs aid the economy. For starters it is axiomatic that having a target pay cash to departing stockholders, makes a target company less creditworthy than would otherwise be the case. Perhaps, if sponsors can make companies more efficient operations than they would otherwise be, a case for LBOs aiding the overall economy would exist. However, we have not seen evidence that LBO sponsors are particularly adept at improving operations. To date Hertz has been a mediocre operation. LBO sponsors can help target companies by giving them superior access to all capital markets—both credit markets and equity markets. However, with the focus on net present value; that is, getting cash out of the target, all too often sponsors preempt access to capital markets for themselves and their investors rather than for the target company. This seemed to have been the case for Hertz, except in 2009.

Given such super access to capital markets, there is no question in our minds that becoming a limited partner in investment funds run by CDR, Carlyle, or Merrill Lynch is an attractive option for OPIMs. The history of investor returns while the sponsors controlled Hertz is ample evidence of this. Because LBOs weaken credit worthiness *ab initio* and maybe during the life of the LBO ownership, the risks of a target company failure seem to be much above average. However, we think an OPIM would probably fare quite well could he, she or it become a limited partner financing, say, four or five Hertz-like transactions.

SUMMARY

Despite mediocre operating results subsequent to the LBO, the Hertz Global Holdings Transaction

seems to have been quite remunerative for the LBO sponsors and their investors. In our view, this success is attributable mostly to the fact that time and again the sponsors enabled holders of Hertz Global Holdings common stock to obtain super-attractive access to capital markets. For example, sponsors and investors received two large dividends where the funds for paying one of the dividends came from a loan with liberal covenants, and for the other, from the proceeds of an underwritten common stock offering to the public. Sponsors have proven to be very skillful resource converters who appear to be very sensitive to the needs of bankers and the Wall Street underwriting community. We briefly discuss LBOs from the points of views of investors, the company and the economy.

CHAPTER 26

The Use of Creative Finance in a Corporate Takeover*

The Case

The Postscript

Investment Lessons

The Appraisal of Management

Spotting Doable Deals

Summary

If you are involved in corporate takeovers or mergers and acquisitions, commonly your most important problems do not revolve around whether a proposed acquisition is attractive on its own financial merits. Rather, the more usual problems revolve around whether or not a deal is doable: Can you actually obtain control or consummate a merger or other corporate reorganization at a cost that keeps the bargain a bargain? From a control buyer's point of view, it always is much easier to ferret out corporations whose stocks are selling at bargain prices than it is to get control of these corporations.

THE CASE

The subject covered in this chapter is how Leasco Data Processing Company—better known as Leasco and later named The Reliance Group—in the summer and fall of 1968 financed the purchase for cash of the large-block holdings of common stock of the Reliance Insurance Company. The purchase of the Reliance blocks was the key to making the takeover of Reliance by Leasco doable. And to make the Reliance deal doable, Leasco was willing, even anxious, to give investors who would put up the \$57.5 million needed an outstandingly attractive bargain.

There never was any serious question that Reliance would be a uniquely good acquisition for Leasco, provided Leasco could obtain control of Reliance by issuing Leasco equity securities in the form of Leasco subordinated debentures, preferred stocks, common stock or warrants, or combinations thereof.

In the late 1960s, old-line, conservatively managed fire and casualty insurance companies were genuinely attractive acquisitions for *conglomerateurs*. Not only did Leasco acquire Reliance (after being moderately hindered by competition from Data Processing Financial and General Corporation), but also, *inter alia*, Home Insurance was acquired by City Investing, Great American Insurance by National General Corporation, and Hartford Fire by International Telephone.

Insurance company stocks tended to be depressed because the companies were suffering underwriting losses from their pure insurance operations, and the stock market emphasized earnings from operations rather than other elements that made insurance companies valuable, namely, the steadily increasing profits from dividends and interest on their investment portfolios, and the huge pools of liquidity built up through their holdings of marketable bonds and stocks. Most important, it seemed likely to the acquirers that a good portion of this liquidity (called redundant capital or surplus-surplus) could be removed from the insurance companies and used by their new parents.

Over and above the possible use of surplus-surplus, insurers such as Reliance and Hartford Fire were attractive to acquisition-minded companies, such as Leasco and ITT, for two additional reasons. First, there was the opportunity to manage earnings to be reported to stockholders in the future, but only if the acquisition could be accounted for in reports to stockholders through the use of pooling of interests accounting rules as they then existed (prior to November 1, 1970) rather than through purchase accounting. The insurance companies had invested a portion of their assets in common stock portfolios that by the late 1960s had enjoyed substantial market appreciation. If the insurance companies could be acquired under a pooling, the acquiring companies would carry the insurance companies' portfolios in their own books at the insurance companies' original costs. In a purchase accounting situation, on the other hand, the acquirers would have to write the insurers' portfolios up to the portfolios' market values and, in addition, would probably have to reflect as an intangible asset the excess of the acquirer's purchase price over the market value of the insurers' assets. (The acquirers' purchase price would be measured by the market value of the securities issued by the acquirer to consummate the takeover.)

Of course, if pooling occurred, the acquirer could virtually assure itself of being able to create future earnings in reporting to stockholders, because in order to create such instant earnings, all that Leasco or ITT would have to do would be to sell off (or to induce their insurance subsidiaries to sell off) common stocks for which the cost basis was well below market. The difference between proceeds of securities sales and the cost basis for the securities would equal earnings that could be reported to stockholders.

At the time it was endeavoring to acquire Reliance, Leasco knew through Reliance's consolidated balance sheet that as of December 31, 1967, the insurer's common stock portfolio had a carrying value of \$110.8 million, compared with a market value of \$215 million. By the summer of 1968, the market value of that portfolio had appreciated. If pooling were used, Leasco, in its consolidated statement to be issued after the Reliance takeover, would carry the Reliance portfolio at \$110.8 million. Even assuming that all warrants were exercised (which would bring a lot of new cash into Leasco) and that all convertible securities were converted, Leasco would still have fewer than 10 million common shares outstanding. So, at the worst, there was a maximum potential for the creation by Leasco of over \$10 per share of instant pretax earnings, provided it could pool Reliance. The ability to pool Reliance would give Leasco a reservoir of future earnings that it might be able to call upon and that, after 25 percent capital gains taxes, would still be in excess of \$7 per share. This was viewed as quite a potential windfall by Leasco, which up to that time had never in any one year earned as much as \$1 a share since it started business in 1961 (although Leasco stock was, in July 1968, selling between 65 and 70).

Leasco, though, it should be noted, would not have complete influence over the creation of instant earnings, since by contract the assets that remained in Reliance were to be under the control of the old Reliance management; however, insofar as Leasco would be able to extract assets from Reliance, it would have full control over the creation of instant earnings by selling low-cost stock out of its portfolio.

An additional area of attraction in acquiring companies such as Reliance and Hartford Fire was that they gave the acquirers entrée into the financial services industry. In particular, Leasco thought that the acquisition of Reliance, with its huge resources and widespread sales force coupled with Leasco management, could provide the foundation for building a financial empire that might encompass not only leasing and insurance, but also areas such as mutual funds and commercial banking. As a matter of fact, within three months of its acquisition of Reliance, Leasco turned its attention to acquiring control of Chemical New York, the parent company of Chemical Bank and Trust Company, the nation's fifth-largest commercial banking institution. The stab at Chemical by Leasco was not only abortive, but also ill advised. It apparently resulted in the withdrawal of Wall Street sponsorship from Leasco,¹ and at the minimum contributed to Leasco's

inability to consummate a public underwriting in 1969 or 1970, which has much to do with the outcome of the story that is the subject of this case.

Early in 1968, Leasco became convinced that Reliance would be a desirable acquisition. Leasco was a small computer leasing company founded in 1961 and run by Saul Steinberg, who at that time had not yet reached age 30. For the year ending September 30, 1967, Leasco's total income was reported at \$14.4 million, and its net income was reported at \$1.8 million before taxes and \$1.4 million after taxes. Stated net worth was about \$16 million. The Leasco equity in mid-1968, though, was valued in the stock market at around \$120 million. Reliance, on the other hand, had net premiums earned of around \$300 million in 1967; its net income was almost \$20 million, and its stated net worth was \$230 million. Before Leasco became interested, the value the stock market placed on Reliance's equity rarely exceeded \$190 million. By any reasonable non-stock-market statistical measure, Reliance was 10 times the company Leasco was. But by the one most important stock market measure—stock price—Reliance was only about one-and-one-half times the company Leasco was; and in addition, Leasco was on the move up, whereas Reliance seemed to be going nowhere.

Leasco became interested in Reliance after it had been solicited by the then New York Stock Exchange member firm of Carter, Berlind and Weill through a report written by a security analyst, Edward Netter, who specialized in insurance stocks. For their services, Carter, Berlind and Weill received a fee of \$750,000 after the takeover was concluded successfully. Initially, through early April 1968 Leasco purchased in the open market 132,000 of the 5.5 million Reliance shares outstanding, at about \$33 per share.

In the spring of 1968, the Leasco management, together with partners of Leasco's investment banker, White, Weld, approached the Reliance management about Leasco's acquiring Reliance. Leasco was rebuffed, and Reliance management was probably prepared to continue to oppose Leasco no matter what proposals for a Leasco-Reliance combination Leasco might make. Reliance opposition would make a deal manifestly less doable by Leasco, and less valuable even if it were doable. If Leasco could obtain Reliance management cooperation (or failing that, an absence of Reliance management opposition), it would make a transaction more feasible and more valuable for Leasco for the following reasons:

1. Cooperation, or the absence of opposition, would likely short-circuit any others who might want to bid for Reliance, such as Data Processing Financial and General.
2. Stockholder solicitation would be made immensely easier, because Leasco otherwise probably could not obtain a stockholder list or have Reliance mail an exchange offer on its behalf. Without access to a stockholder list, Leasco would be able to solicit Reliance shareholders only through newspaper advertisements or through a proxy contest, which of itself would result in all sorts of new timing, legal, and administrative problems.
3. Reliance obstruction in the courts and with regulatory agencies—the Securities and Exchange Commission and the Pennsylvania Insurance Commission—would be eliminated if management were at least neutral.
4. With friendly management, a smaller consideration could be offered to Reliance stockholders. When Leasco thought Reliance would oppose, it prepared to offer Reliance shareholders a package of securities consisting of subordinated debentures and warrants, which for tax purposes would be construed to be an installment sale, making it almost the equivalent of a tax-free transaction to Reliance shareholders. After Reliance management opposition was eliminated, preferred stock was substituted for the debentures. This not only resulted in the exchange offer's becoming fully taxable to the Reliance shareholders, but it also created the environment under which Leasco might be able to account for the

Reliance acquisition as a pooling of interests.

5. The removal of uncertainty caused by management opposition made it manifestly easier to assure Leasco that enough Reliance shares would be tendered for control (50 percent) and/or for accounting purposes (95 percent), so that Leasco could account for the transaction as a pooling of interests. With management opposition, it would be difficult to get Wall Street's arbitrage community interested in the transaction; once interested, they would purchase Reliance shares to tender, making a profit not only on the spread in price between Reliance securities purchased and Leasco securities sold short, but also on the soliciting dealer fee of \$.90 per share, which would be paid them for each Reliance share tendered to Leasco. If arbitrageurs thought there were reasonable prospects that the exchange offer would not succeed, they would forgo purchasing Reliance. Contrariwise, confidence in its success would produce the purchasers of Reliance shares to be tendered, resulting in just the type of bandwagon effect that would be helpful in getting stock tendered to Leasco.

Leasco could see, however, that the active Reliance management might be vulnerable. Its shareholdings in its own company amounted to only about 43,000 shares. There were in existence blocks of Reliance stock, the equivalent of almost 800,000 shares (or 14 percent) of the outstanding stock, which were held by 14 stockholders of record, who had exchanged shares in small insurance companies they owned for Reliance stock, principally in 1963 and 1965. The beneficial owners of these shares were Corroon & Black Corp., and in Chicago, the family of Alfred MacArthur, who was deceased. The Corroon interests and the MacArthur interests each had one representative out of the 17 seats on the Reliance board. They were not part of the day-to-day management. Control of these shares by Leasco might be the lever that would avert active opposition by the Reliance management.

Leasco, though, could not be sure that even if it obtained control of this 14 percent block, it would be able to induce the Reliance management not to oppose a tender. First, virtually all these shares were in the form of Reliance Class A common, and the A stock had very limited rights of conversion into Reliance common; indeed, some of the A shares issued would not become convertible until 1979. Each share of Class A common was equivalent in all respects to ten shares of common, except that the A had only one vote per share rather than ten. Thus, although the A shares represented a 14 percent economic interest in the Reliance equity, they represented only a 1.4 percent voting interest; it might take years before that 1.4 percent voting interest could be changed into a percentage that would be of control use for Leasco. Furthermore, even if Leasco were to obtain a majority of Reliance's voting power, it could still take years to obtain a majority of the Reliance board of directors. Reliance had a system of class election under which directors were elected for staggered terms of four years; in addition, there was cumulative voting. Thus, assuming 4 of 16 directors stood for election each year, if Leasco had a majority of Reliance's stock, it might be able to elect only three directors a year: it would take Leasco three years after it had a majority of Reliance's stock to elect a majority of the board of directors.

Against this background, Leasco's strategy was to attempt to tie down this 14 percent block, so that Leasco could call upon it in the event it obtained a majority interest in Reliance. If Leasco were armed with the potential ownership of a 14 percent equity interest in Reliance, it felt it might be able to bargain with the Reliance management, so that it would no longer oppose a tender, and indeed, with luck might even favor it.

The A holders made it known in July 1968 that they might be willing to commit to sell their shares to Leasco, but they wanted two things—cash, not Leasco paper, and a premium above the then market for Reliance common. Leasco accommodated them, entering into an agreement with the Corroon & Black and the MacArthur interests on July 23, 1968, at which time Reliance common was selling at 69. The essential elements of the July 23 agreement were as follows:

1. If Leasco accepted any Reliance shares under the tender offer it

proposed to make, Leasco would be required to buy all these Corroon and MacArthur shareholdings for \$72 per share in cash. If Leasco did not accept any Reliance shares under the tender offer, it would not be required to purchase any of these shares.

2. Payment of the \$72 was to be made either by Leasco directly or by arranging that these selling shareholders tender their Reliance shares for Leasco securities, which would then be immediately sold to certain designated buyers to yield the sellers \$72 per share in cash for their Reliance holdings. This latter provision became operative, and the \$72 purchasers in September were a group of institutional investors.

By virtue of the July 23 agreement, Leasco had tied down this 14 percent interest without any cash outlay. It would only be committed to purchase them if Leasco obtained a majority of the Reliance shares, because of the terms of the tender offer that Leasco need not acquire any Reliance shares unless 50 percent of the outstanding stock was tendered. Furthermore, under the July agreement Leasco in effect obtained an option either to use its own cash and borrowings aggregating \$57.5 million for the purchase of these shares or to substitute a third party or parties that would purchase Leasco securities from the Corroon and MacArthur interests for the same \$57.5 million.

Under the terms of the exchange tender offer, the Leasco securities to be issued for a maximum of 5,582,540 Reliance shares were to be as follows: For each Reliance common share, Leasco was to exchange one share of Leasco Series B convertible preferred stock, convertible into Leasco common at \$90 per share (or into .6111 Leasco common), and one half of a Leasco warrant, two of which would entitle the holder, for a period of 10 years, to buy one share of Leasco common at \$87 per share.

With the July 23 agreement a *fait accompli*, Leasco now reentered negotiations with the Reliance management. These negotiations, unlike earlier efforts, were successful: Reliance management agreed to be neutral in connection with the forthcoming tender offer, and to (or in any event, did) mail the Leasco tender offer to all Reliance shareholders. The substance of the Leasco-Reliance pact was embodied in an August 1, 1968, agreement, the principal terms of which were as follows:

1. Reliance management would not oppose Leasco's removing the surplus-surplus from Reliance, an amount that Leasco estimated was about \$125 million.
2. For five years, Leasco was to elect only one third plus one of the Reliance board of directors.
3. Reliance was to take no action outside the ordinary course of business without the affirmative vote of at least two thirds of its directors.
4. A. Addison (Bill) Roberts was to continue as chief executive officer and a director of Reliance. Parallel to this, Mr. Roberts also obtained a long-term employment contract at a substantial pay increase. The long-term contract for Bill Roberts probably protected Leasco at least as much as it did Roberts, because he was viewed as an exceptionally able operating insurance executive.

With management opposition removed, Leasco was ready to make its tender offer to exchange the package of Leasco preferred and warrants for Reliance common. The offer was made on Monday, August 19, 1968. The previous Friday, Leasco common had closed at 87.625; thus, if the preferred stock to be issued on a share-for-share basis for Reliance common was valued at its conversion parity (.6111 common), it would have a market value of \$53.55 per share. In addition, warrants exactly the same as Leasco was proposing to issue in the exchange were already trading over-the-counter at about \$43 per warrant. The market value of the Leasco package, consisting of one preferred and one-half warrant, was therefore \$75.05 (or \$53.55 plus half of 43). Reliance

closed on August 16 at 66.5; Reliance shareholders were induced to tender for the Leasco package because of the almost nine-point spread between the market price of the Leasco package and the market price of Reliance common.

The Leasco exchange offer was a rip-roaring success, and by the second week of September it became obvious that Leasco not only would obtain control of Reliance, but also would obtain over 95 percent of the Reliance stock, in which event Leasco's independent auditors, Touche Ross and Co., would permit the Reliance acquisition to be accounted for as a full pooling of interests, provided other necessary conditions were met.

Now Leasco was faced with the problem of paying for the shares to be purchased at \$72 cash from the Corroon and Black and the MacArthur interests in accordance with the terms of the July 23 agreement. Leasco believed it could pay for the shares from its own treasury, because it now had \$46 million, most of which had been raised almost concurrently through the sale of Eurobonds by a new Leasco subsidiary, Leasco World Trade. However, Leasco clearly preferred to have the \$57.5 million paid by third parties for two reasons. First, Leasco believed that if it reinvested its own funds into productive activities rather than in the repurchase of its own securities, it would grow much faster. Second, insofar as Leasco itself repurchased this 14 percent interest, it would be unable to fully pool Reliance's accounting data, but would instead be stuck with a now extinct accounting hybrid—part pooling, part purchase. Full pooling meant more benefits for future earnings than part pooling, part purchase.

Leasco turned to White, Weld to structure a package that third parties would buy. By the second week of September, the Leasco package had a stock market value of around 80 to 83 per unit. However, for the amount of units involved (799,050), it was too much to expect the third parties to pay the Corroon and MacArthur groups \$72 per unit in cash virtually simultaneously with these groups' having exchanged their Reliance shares for the Leasco package. No third party buyer would be able to sell that amount of Leasco equity in the open market at 80 to 83 in the absence of a registration statement with the Securities and Exchange Commission. Offering about 800,000 of Leasco units at this time by what the market might interpret as being quasi-insiders might also depress the market from its 80–83 level.

Against this background, White, Weld and Lehman Brothers, which were now acting jointly as Leasco's main investment bankers, structured a deal that would be inordinately attractive to their institutional clients. In effect, Leasco would use its credit to guarantee that, at worst, a purchaser of the units for \$72 could at the end of one year obtain his money back plus a return of 15.6 percent, most of which would be taxable as a capital gain. At best, the purchaser would obtain for his units \$72, plus \$.75 for each month the unit was held, plus a participation in the profits to be realized over \$72, and plus \$.75 per month in the event the units were sold pursuant to a planned public underwriting of these preferred shares and warrants. The investors were to obtain one half of the gain from the underwriting, as measured by the difference between 90 and 72, plus \$.75 per month. Leasco was to pocket the other half. Insofar as the units were publicly sold at a price in excess of 90, the investors were to have one quarter of that gain and Leasco three quarters. With a buoyant market for Leasco, these investors might even be able to obtain a return of 55 percent or more on a no-risk or low-risk investment.²

This deal was embodied in a three-party contract, the exchange and purchase agreement (E&P), which was dated September 17, 1968, and which was closed on September 19, the day the Leasco package attained a market value of 88.625. The pertinent terms of the E&P were as follows:

1. There were three parties to the E&P, namely, the selling stockholders, the purchasing investors, and Leasco.
2. Sellers were to tender their Reliance shares in exchange for the Leasco package, and the purchasers were to acquire the Leasco package from the sellers at \$72 cash per unit.
3. For the next year, the purchasers were to be guaranteed by Leasco proceeds of not less than \$72 per share, plus \$.75 for each month or portion thereof that the Leasco package was held by the purchasers. This \$72 plus \$.75 was known as "the guaranteed price."
4. The purchasers were to be given one half of the difference between

\$90 and the guaranteed price in the event that the units were sold, and also were to obtain one quarter of the guaranteed price in excess of \$90.

5. Leasco was to arrange at its own expense (if it could) that these units would be registered with the Securities and Exchange Commission, so that they could be sold publicly, preferably through an underwritten public offering.

It is interesting to see who the institutional investors who purchased this package were (see [Table 26.1](#)), since they appeared to be a more or less typical cross-section of trusts, pension plans, mutual funds, and insurance companies.

Table 26.1 Composition of Institutional Investors and Their Subscription Percentages

Institution	% of 799,050 Units Subscribed	In their Capacity as
Continental Illinois National	28%	In various fiduciary capacities
Chase Manhattan Bank	26%	Various employee benefit trusts
Commonwealth Capital Fund, Inc.	9%	Fund
Technology Fund, Inc.	5%	Fund
U.S. Trust Co., as trustee and/or	5%	Agent
Yale University	5%	
Connecticut General Life	3%	Insurance company
Bankhaus Burkhhardt	2%	
State Farm Mutual Automobile	2%	Insurance company
Banque de Financement	2%	
Banque Lambert S.C.S.	2%	
N. M. Rothschild & Sons	2%	
Employers Mutual Liability	2%	Insurance company
Exchequer Associates	2%	

Old Kent Bank,	2%	
trustee		
L.D.P. Associates	2%	
State Farm Life	< 1%	
Insurance Co.		
State Farm Fire &	< 1%	
Casualty		
General American	< 1%	
Life		
First National Bank	< 1%	Agent
of Chicago,		
TOTAL	100%	

First and foremost, the transaction provided the investors a very high return of 15.6 percent, at a time when Leasco was borrowing from banks at 6.5 percent to 7.5 percent. The investment, therefore, had considerable safety because of the Leasco guaranty. The return of 15.6 percent would be obtained as follows if the investors held the Leasco package for the full year:

Dividend of \$2.20 on	\$2.20
convertible preferred	
\$0.75 per month for 12	\$9.00
months	
Cash return	\$11.20
Rate of return on \$72 purchase	15.60%
price	

Most of the return had better tax-shelter characteristics than it would have had if it had been taxable to the investors as interest income. The \$9 in particular was taxable at capital gains rates. This tax-sheltered return to the investor would not *per se* result in diminished tax payments to Internal Revenue, because Leasco was not able to deduct from its tax return preferred dividends or any payments of the guaranteed price, as it would interest payments.

However, 15.6 percent was only the minimum return to the investors. Remember that at the time that the E&P closed, the Leasco package had a market value of 88⁵/₈. Suppose that in about six months there could be a public offering of the units at 85 net; the investor would then receive a return at an annual rate of 27.4 percent, all with having undertaken only very minimal risk. The 27.4 percent return would be computed as follows:

6 months' dividend of \$2.20	\$1.10
on convertible preferred	
\$0.75 per month for 6 months	\$4.50
½ of the difference between 85	\$4.25
and the guaranteed price of	
\$72 plus \$4.50	
Total cash return	\$9.85

6 months' rate of return based 13.70%
on \$72 purchase price
6 months' annualized rate of 27.40%
return

Even the 27.4 percent return must have seemed modest during this period, because Leasco was a dynamic market performer; one could just as soon have postulated a public offering for the Leasco package at 95, 105, or 115, rather than at 85.

From Leasco's point of view, if the public offering had been consummated in, say, six months at then-prevailing market prices, Leasco would not only have purchased the key block necessary for it to obtain control of Reliance with virtually no cash outlay, it would also have made money on the deal. Depending on whether the price of a public offering six months later was 85, 95, or 105 net, cash inflows to Leasco per unit from the operation of the E&P would have been as follows:

	Public Offering Price per Unit		
	85	95	105
Cash outlays by Leasco:	\$1.10	\$1.10	\$1.10
Preferred dividend			
Cash inflow to Leasco: 1/2 of difference over \$76.50 (\$72 plus \$4.50 to price of 90)	\$4.25	\$6.75	\$6.75
3/4 of excess over 90	\$0.00	\$3.75	\$11.25
	\$4.25	\$10.50	\$18.00
Net cash benefit to Leasco per unit	\$3.15	\$9.40	\$16.90
Aggregate cash benefit to Leasco	\$2,517,000	\$7,911,000	\$13,504,000

If there had been a public offering as contemplated, both Leasco and the institutional investors would have profited enormously. It was not that both were going to get free lunches, but rather that the stock market public that was willing to pay extra premium prices for Leasco equities was supposed to treat both the institutional investors and Leasco to lunch.

Although the institutional investors had a highly attractive deal whether the shares they held were to be sold to the public at premium prices or whether the institutional investors were to receive only the guaranteed price, the transaction, like all transactions, had some risks and uncertainties. Many of these investors probably realized that Leasco was not the best credit risk in the world; all realized that under the securities laws, they would become statutory underwriters if there was to be a public offering of their units, in which case there would be some exposure to potential legal liabilities. As a matter of fact, a stockholder derivative action was brought by a Leasco shareholder against the institutional investors, claiming that Leasco was harmed because the E&P constituted a loan to Leasco at exorbitant rates and was in violation of margin regulations.³ Nonetheless, the institutional investors did make a highly attractive deal, probably as close to a free lunch as anyone in the financial community ever gets.

Leasco would have done brilliantly had a public offering above the guaranteed price ever taken place. Not only would the July 23 agreement coupled with the E&P have enabled Leasco to create an environment under which it could get control of Reliance relatively easily, but it would also have enabled Leasco to share in the profits created by the sale of Leasco stock that had been issued for Reliance shares.

THE POSTSCRIPT

Unlike the institutional investors, Leasco had meaningful exposure; if a public underwriting was not accomplished by September 1969, Leasco would have had to pay the guaranteed price with its own funds. But subsequent events showed that this was not the worst fate that could befall Leasco; a fair argument could be made that had not Leasco acquired Reliance, Leasco after September 1969 might have been insolvent, or in any event, in quite serious trouble. All Leasco's operations other than Reliance proved to be operating disappointments and cash drains. In early 1974, Leasco was renamed The Reliance Group.

Leasco was unable to accomplish a public offering of the units in 1969. We are not certain of the reasons for this, but it seems a fair guess that Leasco's abortive attempt to acquire control of Chemical Bank in early 1969 was a contributing factor. It should be noted, too, that during early 1969 the market prices of virtually all computer-leasing stocks weakened. The Wall Street community rapidly withdrew support from Leasco, and its investment bankers produced various stated reasons for no longer underwriting Leasco securities.

By July 1969, Leasco was attempting to extend the terms of the E&P until October 1970. Many of the original institutional investors, holding about 25 percent of the units, refused to go along. Leasco found other institutional investors to take their place by paying the original investors the guaranteed price of \$81 (\$72, plus \$.75 for each of twelve months). In order to induce the other original institutional investors and the new institutional investors to, in effect, extend the E&P, Leasco offered the original E&P terms plus a bonus that was to depend on stock prices and was to be anywhere between \$1 per unit and \$3 per unit; it ended up being \$1 per unit. However, the second E&P probably was not as attractive as the first year's E&P; unlike September 1968, September 1969 was not a time in which most people were caught up in euphoric optimism about how wonderful a stock market performer Leasco was likely to be in the next year. On October 1, 1970, Leasco had to make good on its guarantee, at which time it repurchased all 799,050 units at the guaranteed price for an aggregate cash outlay of over \$72 million. By 1970, this put quite a crimp in Leasco's finances.

INVESTMENT LESSONS

In our view, the transactions described here are examples of the types of creative finance that can be used to accomplish corporate objectives, and of how astute investors can be prime beneficiaries of the product of someone else's creative finance. The essential ingredient that created the environment that permitted the institutional investors to come close to getting a free lunch was the stock market appraisal of Leasco. As long as the public might be willing to pay ultrahigh prices for Leasco equities, Leasco was more than willing to give the institutional investors the benefit of a bargain, just so long as it helped Leasco obtain its objectives. Leasco's objectives were to obtain control of Reliance by paper only, not cash; to account for the Reliance acquisition as a pooling; and to not commit to purchase a large block of Reliance stock unless that block was part of a control block. The institutional investors aided Leasco in those goals.

It is probable that the type of opportunity that was offered here to the institutional investors would never be available to outside, passive investors who lacked know-who. Yet, we feel the case is instructive for all our readers because:

1. It serves as a good example of the types of things many intelligent people are involved with in the finance industry.
2. It gives the reader an insight into a financial instrument with which he may not be familiar, namely, the guaranty.

The Leasco-type guaranty is something commonly used in private transactions, in part because it results in capital gains treatment for the buyers' profit and an off-balance sheet liability for the issuer of the guaranty. In fact, the types of arrangement found in the E&P is known by

many as a put-call agreement. *Put* means that the holder of a security can require someone else, under certain conditions, to repurchase that security: That is, the institutional investors could force Leasco or Leasco's nominee to pay them the guaranteed price at the end of a year. *Call* means that the holder can be required by someone else to sell the security he holds: That is, Leasco could, as a practical matter, have required the institutional investors to sell their holdings, as long as the institutional investors got at least the guaranteed price plus a market appreciation participation, if any.⁴

Whether or not a deal is potentially doable is an important market consideration. Reliance stock was undoubtedly a very sound, fundamental value in late 1967 and early 1968 when it was selling in the mid-30s. If the company had been invulnerable to takeover and wholly uninterested in merger, it is fair to say there might have been moderate appreciation as earnings improved and as the market gave increased recognition to the business's exceptionally good quality. But it is very hard to postulate that without Leasco, or someone like Leasco, in the picture the market values attributable to Reliance common would have been in the 80s in the fall of 1968 and over 100 in late 1968 and early 1969. Leasco would not have been in the picture if it was obvious that Reliance was not a doable deal.

The Leasco-Reliance transactions raise three very interesting questions, good answers to which are certainly a (if not the) royal road to investment riches.

1. How do you appraise managements such as Leasco's?
2. How do you spot doable deals such as Reliance's before someone else does?
3. How do you get to be an institutional investor who is shown highly attractive private financings such as the E&P?

THE APPRAISAL OF MANAGEMENT

The Leasco management showed a high, even rare, degree of ability in first recognizing the values of Reliance to Leasco, and in then engineering the takeover. Many conglomerate managements in 1968, on the other hand, demonstrated no abilities other than a knack for promoting the prices of the stocks of the companies they controlled. These others were just good at go-go. Not so with Leasco. The Reliance takeover represents strong evidence that Saul Steinberg and his associates were intelligent, resourceful businessmen who understood not only how to avoid the risks of committing cash to a deal that might not be doable, but also what their company needed in the way of an acquisition and how to get it.

Yet, within a few months Leasco came a cropper, and the company was unable to close out the Reliance transaction by selling securities to the public rather than by using Leasco's corporate cash. It is possible that Leasco's inability to close the Reliance transaction via a public offering of the securities held by institutional investors was absolutely beyond its control. Market prices did sag in 1969. It is possible, too, that the Leasco management itself was a major contributor to the company's inability to obtain a public offering: the abortive stab at acquiring Chemical Bank in February 1969 used up much of the goodwill and high regard Leasco had built up in the financial community. Whereas engineering the acquisition of Reliance was evidence of management brilliance, coveting Chemical was evidence of management insensitivity and stupidity, and yet both were the same management.

Which type of dealmaker was the Leasco management? Brilliant, or insensitive and stupid? In our view, it was both. It accomplished a major financial *tour de force* in 1968, but came a cropper in 1969. Brilliant management in one context is not necessarily brilliant management in another; those who are good dealmakers at one time may be bad in another period. A talent for obtaining operational efficiency, for example, may obscure a predilection for misunderstanding sophisticated finance. In 1968, there were good stock market reasons for equating good management with aggressive management; in 1975, 2007, and 2008 there were good stock market reasons for equating good management with nonaggressive management (those whose policies kept their

companies liquid). It is not necessarily contradictory that the same Leasco people who were such brilliant deal makers in 1968 were somewhat less than brilliant after 1969; it is possible that the same boldness that contributed to their company's positive accomplishments in 1968 also contributed to Leasco's failures after 1968.

Because it is so difficult to appraise managements, we do not believe that outside investors should, as a rule, pay premium prices to invest in the stocks of companies with superior managements. There usually are available many common stocks of good-grade companies where management is superior and where the price of the stock does not reflect that superiority.

On the other side of the coin, we think all investors should avoid the securities of companies deemed to have bad managements, regardless of the price of the equity security. This is an essential element of the fundamental finance approach. Bad managements are, in our view, easier to spot than good managements. Bad managers are marked by self-dealing and/or ineptness in virtually all areas except one—protecting their own positions. *Bad management*, it should be noted, does not specifically refer to managements that do not contribute to their companies' having favorable stock market prices. Reliance had good management before the Leasco takeover, because they were skilled in operating a large insurance business as a going concern. As a matter of fact, one of the factors to look for in spotting doable deals is companies that are well managed, at least in the custodial, going concern sense. It is an untrue and misleading myth that companies seeking acquisitions—for example, Leasco—look for companies with bad managements. The opposite is true. Leasco would not have been interested in Reliance if they did not believe it was a well-run going concern. To have been interested otherwise when Leasco had no operating experience in the insurance industry would have been really stupid.

SPOTTING DOABLE DEALS

There is a school of thought that contends that the most doable deals are those where shares are widely held and actively traded, and where directors and management own very little stock. This certainly was not the case for Leasco-Reliance, where there were blocks that accounted for 14 percent of the common stock issue; if those blocks could be tied up, Reliance would become (as it did) quite doable, and if it could not, the prospects for obtaining control would have been quite discouraging. Thus, there are no hard and fast rules by which an outsider without any inside contacts can tell whether a specific situation can or cannot be a doable deal. Rather, frequently in a corporation there is a person or a few people who can deliver control, either by active cooperation or by a failure to oppose a takeover. Among potential acquirers, there are those who would try to accomplish an acquisition in a contested takeover and those who would never contest for control, regardless of how attractive the target company is or how much the acquirer needs to get control of the target. You usually cannot know who would do what without information from the people who will be active doers. In other words, you need know-who.

This inability of outsiders lacking know-who to spot doable deals brings out another point for these investors. It probably pays to diversify⁵ such a portfolio of securities. Reliance was an excellent value in 1968, but without takeover activity it might have been a mediocre performer. We do not know of any *a priori* way for outsiders to spot such takeover interest where there is a lack of know-who, but it is our feeling that a portfolio of five Reliances bought at any time would probably work out well, not because all of them would be taken over, but because one or two might.

Although it may be wise to diversify where an investor lacks know-who, there is no logical course but to concentrate in areas where the investor has know-who. We do not mean this in the hot tip sense. Rather, as a hypothetical example, it is logical that Reliance, selling at around 40, would have been a good stock to concentrate in for an investor who was told by a member of the Corroon family that, while no transaction was pending and while he wasn't sure, he would be inclined to sell if someone would offer over \$50 per common share for all their Reliance holdings.

SUMMARY

The 1969 Acquisition of Reliance Insurance Company by Leasco Data Processing Company is a good example of a small business, almost a start-up, obtaining control of a major property and casualty insurance company without having to invest any material amount of cash unless control was actually obtained. In this case we examine the methods by which Leasco Data Processing Company financed the purchase for cash of the blocks of shares of Reliance Insurance Company, which Leasco believed it needed to acquire if it was to obtain control of Reliance. The case is of interest in part because of the extremely attractive consideration that was given to providers of cash so that they obtained (a) a safe, above-average return on a tax-privileged basis as well as (b) an opportunity to participate in potential market appreciation. This was the epitome of an investment that could be deemed to be attractive using the safe and cheap approach. Yet, the transaction was also highly attractive for others, especially Leasco, because it enabled Leasco to tie up key blocks of common stock without risking cash, unless it was to obtain control of Reliance, and also to use pooling of interests accounting treatment in the future, with consequent beneficial effects on Leasco's reported earnings to its stockholders. (The ability of a company to use pooling of interests accounting in connection with an acquisition transaction no longer exists).

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¹ An excellent account of the Leasco attempt to take over Chemical appears in John Brooks's *The Go-Go Years: The Drama and Crashing Finale of Wall Street's Bullish 60s* (Wiley Investment Classics, 1973, 1999).

² Theoretically, the return on equity could have been infinite, assuming that the purchaser securing his purchase with Leasco's credit borrowed all of the purchase price. The purchaser would pay over the one year, say, 7 percent interest, which would compare with his guaranteed minimum return of 15.6 percent. However, the type of investors who bought the deal was institutions, which typically invest their own funds and for which the 15.6 percent to 50 percent return is more appropriate.

³ The suit did not result in any material liability to the institutional investors.

⁴ In fact, the lever in Leasco's call was that if the institutional investors chose not to heed the call, Leasco's guarantee, or put, would no longer be operative.

⁵ We cover the issue of diversification in more detail in Chapter 13.

CHAPTER 27

The Use of Creative Finance to Benefit Controlling Stockholders*

The Problems Faced in the Schaefer Corporation Deal

The Background of the Deal

Discount Purchases of Restricted Corporate Stock

Corporation's Acquisition of Brewing

Problems and Wealth Creation Potentials for the Parties in Interest

Summary

It is likely that more fortunes within the financial community are obtained through the discount purchase of securities in negotiated transactions than through brilliant analysis resulting in the purchase at market prices of securities that will appreciate dramatically. A discount purchase is one in which a stockholder obtains securities at a price below that which prevails or is to be created in a public market.

Only a small minority of the Wall Street success stories come out of an outside investor's acting on a feeling about the growth of a particular industry, such as feeling in 1955 that "copying is going to be a great business; ergo, I shall buy and hold Xerox." Rather, the more common method of amassing wealth in the financial community is to be involved in a deal that enables you to buy common stock at, say, \$.42 or \$1 per share, for which the public has paid or will pay, say, \$26 per share. A large number of deals resulting in such discount purchases have been put together, including, to name a few, Eastman Dillon promoting Westcoast Transmission, American Securities promoting Western Union International, Ladenburg Thalmann promoting Guerdon Industries, and Lehman Brothers promoting Monterrey Oil. Discount purchases are not confined to investment bankers and brokers; other deals have included Albermarle Paper purchasing Ethyl Corporation, Malcolm McLean acquiring certain shipping interests, and Northwest Industries acquiring Velsicol Chemical.

In this chapter, we describe one set of discount-purchase transactions in detail; these culminated in the November 1968 public offering of the F. & M. Schaefer Corporation, parent company of the producer and marketer of Schaefer beer.

The reason for picking Schaefer as a case study is that it is one of the more complex transactions, so that many of the key elements that go into a discount-purchase transaction are covered. It should be noted, however, that an important element not covered in the Schaefer transaction is the use of tax-loss carrybacks and tax-loss carryforwards.

There are a number of valuable lessons to learn from the Schaefer case study. The first concerns the mechanics of such transactions. It is also important to have some appreciation of what goes into Schaefer-type transactions in order to understand Wall Street. Another equally important lesson has to do with understanding the problems and goals of the various parties to the transactions.

The transactions are examined from the points of view of eight different constituencies:

1. The selling stockholders
2. The company's operating executives
3. The commercial bank that provided short-term financing
4. The promoters of the transactions
5. The underwriters who marketed the initial issue to the public
6. The institutional lenders (basically life insurance companies) that provided the bulk of the long-term financing
7. The public investors
8. The new business that emerged as a publicly owned, rather than a closely held, enterprise

Like all things on Wall Street, everything in this transaction, including discount purchasing, had its problems. In some contexts, the public shareholder who was able to obtain stock at \$26 in the initial offering had fewer problems and a more attractive holding than some of the other parties who purchased stock at \$1 per share two months earlier.

THE PROBLEMS FACED IN THE SCHAEFER CORPORATION DEAL

The mechanical problems faced in this complex deal included the following:

- Tax problems, especially for the sellers and the purchasers of discount securities
- Accounting problems for the public company
- Commercial-bank borrowings
- Private-placement borrowings from institutional lenders, such as life insurance companies
- Warrants
- Convertible securities
- Senior loans versus subordinated loans
- Corporate tax shelter (TS)
- Public underwriting
- Rights of registration
- Rule 144
- Cash returns versus no cash returns
- Qualified stock options
- Significance of financial positions in deal making
- Significance of reported earnings for a public company
- NASD Rules of Fair Practice

All the information used here was obtained from publicly available documents, mostly from SEC files. There were no interviews or conversations with anyone associated with the transactions. There is no question that if fieldwork had been done, our work would be more complete. It is also possible that with the personal explanation of those involved in the transactions, certain of our concepts would be changed. This goes with our thesis that in security analysis, studying documents

is no substitute for fieldwork and vice versa. However, the point of forgoing fieldwork is to demonstrate that vast amounts of information frequently are available, so that quite meaningful conclusions often can be obtained by trained analysts relying solely on publicly available documents.

THE BACKGROUND OF THE DEAL

On June 10, 1968, the F. & M. Schaefer Corporation (hereafter called Corporation) was incorporated in New York State. Corporation's purpose was twofold:

1. To acquire all the capital stock of the F. & M. Schaefer Brewing Company (hereafter called Brewing), also a New York corporation
2. To go public via an underwritten public offering

Both of these events did in fact occur less than six months after incorporation. The market for new underwritings was favorable in June 1968. Market players were seeking a reprise of the 1961–1962 new issue spree, in which they had bought issues at the initial offering price and realized a profit when the shares sold at immediate premiums. They were looking for securities of companies in growth industries, especially those that were outperforming their own industries in terms of steadily increasing sales, market penetration and profits. The brewing industry was viewed by many as poised for relatively rapid growth, because the progeny of the post–World War II baby boom were reaching beer-drinking age and because higher profit package sales, especially cans, were taking over from draft beer, which was generally a brewer's lowest-profit margin product.

Brewing, which had been in the beer business since 1842, was a strong, prosperous, family-owned business in mid to late 1968. It had Schaefer beer plants in Albany, Brooklyn, and Baltimore. Sales of Schaefer beer, marketed in the northeastern United States, had increased steadily from 2.8 million barrels in 1958 to 4.7 million barrels in 1967, and in 1968 barrel sales were running some 7 percent ahead of 1967. Market penetration, too, had been on the rise. Beer sales in barrels increased from an estimated 3.3 percent of the industry total in 1958 to about 4.4 percent in 1967. Brewing seemed bound to at least hold its market share in 1968, based on results for the first nine months of that year.

Brewing had been quite profitable and was growing rapidly. Net sales had increased steadily from \$151 million in calendar 1963 to \$181 million in 1967. Income before extraordinary credits was \$2,546,000 in 1963 and had increased year by year to \$5,127,000 in 1967, although operating profits had dipped modestly in 1964 because of a \$1,349,000 pretax expense incurred in connection with promotions by the company at the New York World's Fair. As is true of many private companies, Brewing's profit figures seem to have been conservatively stated,¹ and were reported, after tax accruals, at the approximate maximum income tax rates.

Moreover, the company was well financed. The Brewing balance sheet that would have been available before June 10, 1968, was not public information, but the July 31, 1968, audit statement showed that the company was quite comfortable. Cash and equivalent was \$10,405,000, and current assets aggregated \$40,468,000. Current liabilities were \$19,970,000, leaving working capital of \$20,498,000. The only other liabilities were \$3,029,000 of employee benefits and \$15,210,000 of long-term debt, \$15 million of which was in the form of 5.17 percent notes held by the Prudential Insurance Company of America. These notes matured serially to 1983, but annual amortization during the next six years would be only a modest \$500,000 for 1968 and 1969, and \$825,000 for 1970, 1971, 1972, and 1973.

Tangible asset value was stated at \$53,149,000, probably a conservative figure. Property, plant, and equipment—which included a malting plant in Buffalo, New York, and six distributing centers, as well as the three breweries—was carried at a net value of \$44,877,000, after deducting accumulated depreciation of \$38,841,000. This \$44,877,000 amounted to only \$8.56 per barrel of capacity, based on Brewing's 1967 capacity of 5,240,000 barrels. In light of the fact that replacement costs were running about three times this per barrel of capacity,² Brewing's property,

plant, and equipment seem to have been worth at least the amounts for which they were carried on the books.

DISCOUNT PURCHASES OF RESTRICTED CORPORATE STOCK

A week after Corporation was organized, R. W. Pressprich and Company purchased 160,000 newly issued shares of Corporation common for \$66,667, or \$.42 per share. This was the first discount purchase.

Pressprich, located at 80 Pine Street in New York City, was a medium-sized New York Stock Exchange member firm, which for many years had been highly regarded in the financial community. Pressprich was a principal, if not the principal architect of the Corporation-Brewing transaction and subsequent public offering, and also arranged the financing that gave Corporation the wherewithal to effect the purchase. Pressprich had agreed not to resell these 160,000 shares before March 15, 1971, without first offering them to Corporation at \$.42 per share.

On September 20, 1968, the day Corporation signed a purchase agreement for the acquisition of all of Brewing's capital stock, an additional 170,000 shares of newly issued Corporation common stock were sold at \$1 per share. The purchasers of these shares included members of the Schaefer family, members of the Brewing executive management committee, and a group of institutional investors who were to lend Corporation funds for the acquisition of Brewing. Thus, all of them were providing other benefits for Corporation, either at present or prospectively. The purchasers, their relationship to Corporation, and the special terms of their purchases are shown in [Table 27.1](#).

Table 27.1 Purchasers of 170,000 Corporation Common @ \$1 per Share

Purchaser	No. Shares Purchased	Relationship with Corporation	Contractual Non-SEC Restrictions on Resale
Five members of the Schaefer family	15,000	All were beneficial owners of Brewing's capital stock; two were officers and directors of Brewing (including the two who were officers and directors of Corporation)	Two of five agree not to sell shares, except upon death and disability, until January 1, 1974, and then only 20% per year
Five members of the Brewing executive management committee	5,000	Three of five were also on the board of Corporation	For practical purposes, same restrictions as for the two Schaefer family members above
Seven institutional investors: (1) Equitable Life, (2) New York Life, (3) John Hancock, (4) Mutual Life, (5) New England Mutual Life, (6) Investors Syndicate of America, (7) Investors Syndicate Life Insurance & Annuity Co.	150,000	Lend Corporation \$65,000,000: (1) \$37,143,000 in 7.75% senior notes, due 1989; (2) \$27,857,000 in 5.25% subordinated notes with equity privileges; (3) <i>De facto</i> purchase of stock is conditioned on lending \$65,000,000	No contractual restrictions on resale

As noted, all of the shares issued in these two discount purchase transactions, except the 150,000 purchased by the institutional investors, were sold subject to contractual restrictions on public resale. The shares could be sold privately to another sophisticated holder who would agree to be bound by the restrictions on resale agreed to by the discount purchasers. Such a resale would be unlikely, however, and even if accomplished, the price realized would be a substantial discount (probably 25 percent to 60 percent) from the current market price.

Apart from these contractual restrictions on resale, the 330,000 shares involved were restricted for Securities and Exchange Commission purposes. Accordingly, public resale was limited by law. Under the rules and regulations in effect in 1968, these shares could have been sold publicly only through a registered offering via a registration statement filed with the Securities and Exchange Commission, unless the Commission was to issue a no action letter or a holder was able to obtain a legal opinion that there had been a "change of circumstances." As a practical matter, the chances of any of these purchasers' getting a no action letter or change of circumstances opinion were slim at best.

Thus, at the time of the discount purchases, the only way for the purchasers to sell their Corporation equity securities publicly was by registration with the SEC for a new public offering in which their shares would be sold. As a result, registration rights—an agreement by Corporation to register with the SEC for the distribution of restricted shares—were crucial, at least to those discount purchasers who were not in a position of control in Corporation. Both the institutional investors and Pressprich negotiated fairly strong registration rights, which are discussed at some length later in this chapter.

Since April 1972, Rule 144 had provided holders of restricted stock purchased previously another mechanism for reselling their shares. Basically, under this rule such a holder who had held shares outright for two years might sell them in regular market transactions on the New York Stock Exchange. Back then, Rule 144 provided that the sales could occur only once every three months, however, and the number of shares that might be sold was limited to the greater of 1 percent of the outstanding stock of the company, or the weekly average traded for the four weeks preceding the filing of a Form 144 with the SEC. In this case, 1 percent of Corporation's common stock at the time it went public would have been 18,000 shares.³

CORPORATION'S ACQUISITION OF BREWING

The Purchase Agreement

On September 20, 1968, Corporation signed an agreement under which it was to acquire all of Brewing's outstanding capital stock for \$106 million in cash and notes. This stock consisted of two issues. The Class A participating second preferred stock was owned by Arjayess, a corporation wholly owned by Rudolph J. Schaefer. The Class B stock was held by four trusts set up in 1944 for the benefit of various members of the Schaefer family.

Under the terms of the purchase agreement, Corporation was to acquire the Class A stock for a cash payment of \$6 million. The remaining \$100 million of the purchase price, paid to the holders of the Class B stock, was in the form of a cash payment of \$10 million and various notes, detailed in [Table 27.2](#).

Table 27.2 Consideration Given to Sellers of Brewing's Capital Stock

Seller	Security Sold	Amount and Type of Payment	
Arjayess	Class A participating second preferred	\$6,000,000	cash
Four trusts	Class B stock	\$10,000,000	cash
	minimum of	\$30,000,000	4% note, due 1/15/69 ^(A)
	minimum of	\$40,000,000	4% note, due 7/15/69 ^(A)
		\$20,000,000	4% junior subordinated convertible notes, due 1/15/98 ^(A)
		<u>\$106,000,000</u>	

(A) This 4 percent interest figure probably reflects the minimum interest that could be paid without the Internal Revenue Service assigning "imputed interest" to the indebtedness. This is a crucial consideration, since the consequence of such imputation is to tax the holder of the indebtedness as if he had received interest payments at the imputed rate. Thus, for example, if the IRS chose to impute an 8 percent interest rate to the \$20 million junior subordinated notes, the trusts would be deemed to have received income for tax purposes of \$1.6 million per year. This is precisely the kind of situation where the transaction generates the taxable event, but does not generate the funds with which to pay the taxes owed.

The purchase was contingent upon Corporation's receiving net proceeds of at least \$35 million from a public offering of its common stock. The actual purchase was to take place simultaneously with Corporation's receipt of these proceeds, but not later than December 31, 1968. In fact, the closing took place during the first week of December.

Brewing's officers and employees were to remain in their positions after the acquisition, at the same or improved rates of compensation.

Financing the Acquisition

Corporation needed about \$121.8 million to accomplish this acquisition; \$106 million of this, of course, was the purchase price to be paid to Brewing's selling stockholders. In addition, Corporation needed \$15 million to prepay the 5.17 percent Brewing notes that were held by Prudential Insurance, and \$800,000 to pay expenses incurred in connection with arranging this deal.

Two parties shared the bulk of the \$800,000 expense item. The first was the eminent New York City law firm of White and Case, whose legal fees were around \$350,000. White and Case had represented the Schaefers and Brewing for a long time. One partner, Glover Johnson, had been a consultant to Brewing, on a retainer, since 1955 and was a director of that company. He was also a successor trustee of the four Schaefer trusts, for which he was to receive an annual fee of 2 percent of trust income after 1968. The firm became counsel for Corporation, and Mr. Johnson and his partner, John C. Reed, became directors of Corporation.⁴

In addition to White and Case's legal fees, Pressprich received a fee of \$425,000, primarily for its work in connection with the placement of Corporation's long-term notes. This \$425,000 fee was separate from Pressprich's discount purchase of 160,000 shares of Corporation stock. The bulk of the fee, of course, was conditioned on going public.

After its organization, Corporation obtained \$236,667 in cash from the proceeds of its sales of common stock at a discount. It had also conditioned the acquisition of Brewing on the receipt of \$35 million from its public offering, which would be available to it. Under the terms of the purchase agreement, Corporation had arranged to borrow \$20 million from the Schaefer family trusts, to whom \$20 million of junior subordinated debentures were to be issued. These funds,

aggregating a little over \$55 million, together with the \$6 million surplus cash that Brewing had, still left it considerably short of its \$121.8 million goal, however. To fill the gap, Corporation arranged to borrow \$65 million from the seven institutional investors that had participated in the second discount purchase. Thus, Corporation's sources of funds and securities issued or issuable would be as shown in Table 27.3.

Table 27.3 Sources of Funds and Securities in the Transaction

Source of Funds	Amount of Funds	Consideration to Be Issued by Corporation
Pressprich, Schaefer family, five Brewing executives, and seven institutional investors providing \$65,000,000 of long-term financing	\$236,667	330,000 restricted common shares
Seven Institutional Investors	\$36,142,857	7.25% senior notes, due 1989
Seven Institutional Investors	\$27,857,143	5.75% convertible subordinated notes, due 1989 with warrants
Four Schaefer family trusts	\$20,000,000	4% junior subordinated notes, due 1998
Public, not less than	\$35,000,000 ^(A)	1,500,000 freely tradable common shares
Use of surplus cash in Brewing	\$6,000,000	
	<u>\$125,236,667^(B)</u>	

(A) Public offering actually raised about \$36,000,000 for Corporation.

(B) Excess over \$121,800,000 becomes Corporation funds.

This was not the picture as of the time of the public offering, however. The institutional investors would not lend any funds before January 15, 1969, and their investment was to be phased in over 18 months, according to the following schedule:

Date	Amount to Be Invested at This Date
1/15/69	\$31,845,357
7/15/69	\$8,222,500
1/15/70	\$13,510,714
7/15/70	\$11,421,429
	\$65,000,000

The reason for this phasing is not clear, especially since Corporation was obligated to pay the entire \$106 million purchase price to the Brewing shareholders by July 15, 1969. It may have been due to the investment scheduling requirements of individual lenders, all of which have schedules of cash inflows and outflows, or it may have involved things peculiar to these transactions. In any event, the arrangement left Corporation with a temporary shortfall, which it covered by arranging a short-term loan from First National City Bank of New York at the prime rate.⁵

Corporation's Debt Securities Described

The financing scheme outlined above called for the issuance of \$85 million worth of debt by Corporation. A little over \$36 million of this was in the form of 7.75 percent, 20-year senior notes. The balance was in subordinated notes of varying terms, all of which had equity privileges.

The \$20 million of 4 percent, 30-year notes issued to the Schaefer trusts carried conversion rights. Beginning January 15, 1971, they were convertible into Corporation common at a price of \$40 per share. This conversion price could be reduced on January 15, 1972, to the average price of the stock on the New York Stock Exchange for the 60 trading days prior to January 15, 1972, but in no event could it fall below the initial offering price at which Corporation went public (\$26). Thus, if for the 60 trading days before January 15, 1972, the average price for Corporation common stock was \$40 or better, the 4 percent notes would be convertible into 500,000 common; if the average price was \$35, the 4 percent notes would be convertible into 571,429 Corporation common; and if the average price was \$26 or less, the 4 percent notes would be convertible into 769,231 common.

The 5.75 percent, 20-year subordinated notes issued to the institutional investors were structured somewhat differently. Approximately \$1.2 million of the \$27,857,143 issue was convertible into Corporation common at prices ranging from \$10 to \$6.50 per share (one quarter of the respective maximum and minimum conversion prices for the 4 percent notes), based on the same timetable and the same sixty-day average price formula used for the 4 percent notes.

The remainder of the issue was not convertible. Instead, the seven institutions received warrants, exercisable beginning January 15, 1971, to purchase 84,866 Corporation common at \$10 per share. Like the conversion rights, the warrants could be adjusted on January 15, 1972, depending on the 60-day average New York Stock Exchange price of the stock, into warrants to purchase as much as 130,563 Corporation common at \$6.50 per share. These warrants were detachable from the 5.75 percent notes, and were transferable upon compliance with SEC registration requirements. The institutional holders had registration rights in connection with both the warrants and the common stock, issuable upon conversion of the notes.

The equity privileges of all of these subordinated securities were protected by antidilution provisions similar to those usually found in publicly held convertible securities and warrants. For example, in the event of a two-for-one stock split, the conversion price would be reduced by 50 percent, so that the holder of the notes or warrants would receive the same proportionate equity share on conversion or exercise as it would have before the split. Assuming, as actually happened, that in 1972 the conversion and warrant prices were reduced to the minimum allowed, then in the event of such a split, the 4 percent notes would be convertible at \$13, and the 5.75 percent notes or warrants at \$3.25.

While the antidilution protections accorded these subordinated notes are fairly standard, other features of the subordinated notes are quite different from those commonly associated with publicly held senior securities with equity privileges. Particularly noteworthy in this regard are the provisions for mandatory and voluntary redemption, and the various protective provisions granted the holders of these notes.

Mandatory Redemption Provisions

The conventional public issue of senior securities with equity privileges has only very small amortization, or sinking fund, provisions that operate in the early years after issuance. For example, a typical 20-year publicly owned subordinated debenture might have a sinking fund provision that becomes operative after 10 years and provides thereafter for annual redemptions of 3 percent of the issue at par.

A relatively small sinking fund provision does, of course, operate to the benefit of the public holder of a convertible note. Rapid payback of debt to such an investor would diminish the value of his conversion privilege by "forcing conversion" whenever the market price exceeds the conversion price at the time of redemption.

This phenomenon of forced conversion is best explained by a concrete example. Assume that

Corporation calls for redemption \$1 million of debentures convertible at \$6.50 at a time when its stock is selling for \$8 a share. The holder of the debentures can redeem them at par, realizing \$1 million. But his conversion privilege entitles him to receive 153,846 shares of common stock. If he sells these shares short at \$8 when the redemption is announced, converting the debentures to make delivery against the short sale, he will realize \$1,230,769 before commissions and other trading costs of the short sale. The economic benefit of this latter strategy—in this case, \$230,769—is what forces conversion. Such forced conversion will, of course, occur whether the redemption of the convertible notes is pursuant to a mandatory sinking fund provision or to a voluntary (by Corporation) call.

In the context of this deal, the interests of the Schaefer family trusts in terms of sinking fund provisions were essentially the same as that of a public holder of a convertible note. Accordingly, the mandatory redemption provisions governing the 4 percent notes were similar to those for a typical public issue: The sinking fund was not to become operative until January 15, 1979, about 10 years after issuance; thereafter, annual redemptions at par would amount to \$500,000, or 2.5 percent of the original issue, until the debt held by the institutional investors was to be retired in 1989; annual redemptions would then double for the last 10 years, leaving a \$6 million unamortized balance, payable at maturity.

The interest of the institutional investors involved in this deal was somewhat different: a steady and relatively rapid payback of their loans, rather than a straight conversion privilege, was their primary goal. Accordingly, the 5.75 percent notes issued to them had sinking fund provisions requiring annual redemption at par of 6.25 percent of the debt outstanding, beginning January 15, 1974, five years or less after issuance. In dollar terms, this amounts to annual redemptions of \$1.7 million for 16 years. This redemption scheme does not diminish the value of the institutional investors' equity privileges, because of the way in which those privileges were structured. The great bulk of the 5.75 percent notes were accompanied by warrants that, as noted above, were detachable from the notes. As to the \$1.2 million of debt that was in the form of convertibles, the institutional investors were protected by a provision that in the event of prepayment, warrants to purchase would be issued in lieu of, and on the same basis as, the conversion privileges. These warrants were to expire in 1989.

Voluntary Redemption Provisions

Typically, the issuer's right to voluntarily call a publicly held subordinated debenture with equity privileges is pervasive. The issue is callable in whole or in part anytime after issuance at par. Thus, the issuer is in a position to force conversion if the price at which the common stock is selling is above the price at which the senior security is convertible.⁶ Corporation's voluntary call provisions were quite different from those typically found in connection with a public issue.

The 5.75 percent notes carried a five-year call protection, so that Corporation could not voluntarily redeem the notes until January 15, 1974. After that, Corporation could voluntarily redeem \$1,740,884 of notes at par each year. No additional calls were permitted until January 15, 1979; thereafter, such calls were permitted, but only at a premium. The prepayment premium was 105.75 percent of par in 1979, declining gradually to par in 1988.

The 4 percent notes carried an eight-year call protection. Thus, there could be no voluntary call before January 15, 1977. After that date, the notes were callable at a premium—104 percent of par in 1977, gradually declining to par in 1998. In addition, Corporation was granted rights to voluntarily call \$500,000 of notes per year at par beginning January 15, 1979, and \$1 million of notes per year beginning January 15, 1988.

Protective Provisions

The usual public issue of subordinated debentures or notes, or even preferred stock, tends to have protective provisions that are few and generally not too meaningful. The protective provisions of the 4 percent notes issued to the Schaefer family trusts were similarly skimpy. Indeed, if anything,

these notes were less well protected than the typical public issue, since they were fully subordinated not only to the senior notes, but also to the subordinated notes held by the institutional investors.

The notes held by the institutional investors, by contrast, contained protective provisions that were far stronger than those found in any publicly traded subordinated debenture of which we are aware. These included both negative covenants (things Corporation was prohibited from doing) and positive covenants (things Corporation was required to do). For example, the terms of the purchase agreement under which these notes were issued required Corporation to maintain a certain minimum working capital at all times, and limited amounts that could be borrowed by Corporation and by its subsidiaries, depending on certain earnings and net tangible assets tests. It also imposed restrictions on rental charges incurred, dividend payments, the repurchase of shares and the voluntary redemption of senior securities. Further, the agreement contained prohibitions against sale and lease-back transactions and against investment in the securities of other companies or entities, other than subsidiaries and the U.S. government.

Other Distinguishing Features

Although, as noted, the 4 percent notes contained fairly insignificant protective provisions, they contained a very interesting and unusual control provision. The holder was given the right to accelerate payment of the entire amount in the event that one person acquired beneficially 30 percent or more of Corporation's voting securities, or two or more holders acquired voting stock of Corporation for the purpose of exercising control. This should have effectively discouraged anyone from seeking to oust the Schaefer family from control of Corporation.

One final difference between Corporation's subordinates and similar publicly held issues that is worthy of note is that they were private placements. Although this statement may seem to belabor the obvious, in fact the status of the notes as the product of purchase agreements between Corporation and the acquirers is significant in terms of the protection afforded the holders. A public debt issue is issued under a trust indenture, which is an agreement, conforming to the SEC-administered Trust Indenture Act of 1939, between the issuer and a large-bank-designated trustee for the debt securities holders. In the event of default or breach of the agreement, the individual holder of a public debt issue is not usually in a position to take action against the issuing company on his own unless he and others represent not less than 25 percent of the outstanding debt issue. Rather, the debt holder has to wait for the trustee to take action. The trustee will take action only in strict conformity with his interpretation of the indenture. Thus, the public debt security holder may be less protected than the public common stockholder, who tends to be free to take legal actions on behalf of all stockholders or the company itself. The institutional investors involved in this deal have an advantage not possessed by public investors, in that they can themselves move rapidly against Corporation in the event of default or breach of the purchase agreement.

Conversely, there may be situations in which the very fact that this issue is held by only a handful of owners places the institutional investors in a less favorable position than that enjoyed by a public investor. For example, if the issuer wants to modify the terms of a loan agreement without recourse to the bankruptcy statutes, it is in a position to negotiate changes with a few private lenders. The issuer cannot, as a practical matter, do so with a trustee for indebtedness or with individual public investors, however. Thus, the private investor may be forced to agree to changes adverse to his interests in order to avoid bankruptcy of the issuer, whereas full service may be continued on subordinated debentures because they are publicly held.⁷

Arranging the Public Offering

On September 26, 1968, a little over three months after its incorporation, Corporation filed a preliminary registration statement with the SEC, showing an intent to offer 1 million shares of common stock at a maximum price of \$26 per share. At the time of the filing, Pressprich was to manage the syndicate that would underwrite the offering, but that firm was soon replaced by

White, Weld and Company, a leading New York City investment banking firm prior to its merger in 1978 into Merrill, Lynch, Pierce, Fenner and Smith. Although White, Weld did not actually execute a written agreement with Corporation or with any of the proposed members of the underwriting group until just before the registration statement became effective on November 27, 1968, it was busy putting together an underwriting group during the incubation period in which the SEC was reviewing and commenting on Corporation's filing. In all, the underwriting group included 128 firms—117 U.S. firms and 11 European businesses. White, Weld, as manager, underwrote 218,000 of the 1.5 million shares offered. The underwriting group also included Dillon Read; Halsey Stuart; Kidder, Peabody; Kuhn Loeb & Co.; Lazard Freres; Paine, Webber, Jackson and Curtis; and Paribas.

The issue was offered for sale at \$26 per share on November 27, 1968, and was an immediate success. The warning in the prospectus that Corporation's large debt load and negative tangible net worth made the issue highly speculative certainly did not depress the price, and may even have been the reason the issue went to a premium. In any case, the stock closed at 31 bid on the date of the issue.⁸

Of the \$39 million gross proceeds from the offering, 6 percent (amounting to \$1.56 per share), was retained as underwriting discount;⁹ \$1,065,000 of this (amounting to \$.71 per share) went to White, Weld for its management fee and for the legal, advertising and other expenses incurred in connection with the underwriting. The balance was paid to certain dealers, including the underwriters, as a sales commission.¹⁰

Corporation incurred expenses of about \$330,000 in connection with the underwriting, over and above the underwriting discount. These included such items as legal fees (\$100,000), accounting fees (\$75,000), printing costs (\$75,000), SEC and blue sky (state security regulation) fees (\$30,000), liability insurance (\$35,000), and transfer agent fees (\$15,000).

Contemporaneously with the public offering, Corporation granted options to its employees to purchase 98,134 Corporation common shares. These were granted pursuant to a qualified stock-option plan covering 200,000 shares of Corporation common, which had been approved on October 30, 1968. These options, which were granted at 100 percent of market value on the date of grant, were good for five years if the holder remained employed by Corporation or a subsidiary. Upon the exercise of the qualified option, Corporation would lend the employee 90 percent of the exercise price at 4 percent interest; 20 percent of the outstanding amount was to be repaid annually for the first four years, the balance in the fifth year. These options enabled the holder to profit on a tax-sheltered capital gains basis from appreciation in the market value of Corporation's stock.

PROBLEMS AND WEALTH CREATION POTENTIALS FOR THE PARTIES IN INTEREST

The Selling Stockholders

The selling stockholders were Arjayess, a corporation wholly owned by Rudolph J. Schaefer, and four trusts for members of the Schaefer family.

There are a number of things that motivated the Schaefers to follow the course of action they did rather than the alternative opportunities that might be summarized as follows:

1. Brewing could have gone public by offering its stock via a Pressprich or White, Weld and Company or equivalent underwriting.
2. Brewing could have remained as it was—as a private company—and

used its borrowing power to incur debt, the proceeds of which might then be distributed to the Schaefer family stockholders.

3. Brewing could have sold out to a larger company—say, been merged into or otherwise acquired by a mass merchandiser, following in a general way the acquisition of Miller Brewing by Philip Morris in 1969, or Hamm’s Brewing by Heublein in 1965.

4. Brewing could have done nothing, in which event cash distributions to its shareholders would have been no larger than annual earnings of around \$5 million per year.

The Schaefer family, through these transactions, obtained by July 15, 1969, some \$86 million in cash on a tax-sheltered (capital gains rather than dividend income) basis, after which they were still left in control of the company. The company, too, was now public, with a huge stock market value in which the Schaefer family expected to participate, at least to some extent. Unlike the other stockholders’ holdings, though, the Schaefer family’s security holdings would provide the four trusts with an \$800,000 annual cash return, because the four trusts held \$20 million of 4 percent convertible debentures, rather than common stock on which it was likely that no dividends would be paid. Assuming that the average price for Corporation’s common stock for the 60 trading days before January 15, 1972, was 40 or more, the Schaefer family interests would own 19.6 percent of Corporation’s equity on an all-converted, all-exercised basis. Assuming, on the other hand, that the average price for Corporation’s common stock for the sixty trading days before January 15, 1972, was 26 or less, the Schaefer family interests would own 26.1 percent of Corporation’s equity on an all-converted, all-exercised basis. In either event, the Schaefer family would control Corporation. The Schaefer family ownership interests are computed as shown in [Table 27.4](#).

Table 27.4 Schaefer Family Ownership Interests Computed under Two Different Price Scenarios

	At Price of 40 or More	At Price of 26 or Less
No. shares outstanding after public offering	1,830,000	1,830,000
No. shares owned by Schaefer family interests of outstanding	15,000	15,000
% owned by Schaefer family interests	0.80%	0.80%
No. shares issuable upon conversion of debt, exercise of warrants and exercise of qualified options	798,134	1,175,057
No. shares issuable	500,000	769,231

to Schaefer upon
conversion of 4%
notes

No. shares to be	2,628,134	3,005,057
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outstanding on all-
converted, all-
exercised basis

No. shares to be	515,000	784,231
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held by Schaefer's

% owned by	19.60%	26.10%
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Schaefer family
interests

Each of the alternative opportunities had special disadvantages. The Schaefer family interests could have contemplated, and may well have studied, merely offering some of the Brewing stock held by Arjayess and the four trusts in a so-called underwritten secondary offering. Such an offering would have resulted in the sellers' realizing cash on a capital-gains basis and would also have left the Schaefer interests in control of a public company. Furthermore, this public company, unlike Corporation, would enjoy considerable financial strength. However, it would have been virtually impossible for a secondary underwriting to be arranged on such a basis that the Schaefer family interests would be able to realize \$86 million in cash. Indeed, Corporation's \$39 million gross proceeds from its underwriting was relatively large for an issue of this type. Not only were the Schaefer family interests able to realize \$86 million of cash from doing what they did, but also they may well have achieved a much better aftermarket for their remaining holdings in Brewing's parent than would have been the case on straight underwriting. Because certain influential Wall Street entities (Pressprich and the seven institutional investors) were important shareholders, Corporation may well have become a better-sponsored security in 1969 and 1970 than would otherwise have been the case. Corporation's stock price rose almost steadily after the initial offering in November 1969, reaching a peak in February 1970, when the shares sold at a price of \$59, equal to 25 times 1969 earnings of \$2.30 per share.

Had Brewing remained a private company, its ability to borrow from lending institutions would have been considerably poorer than as part of a public vehicle. One crucial factor that made the \$65 million borrowing by Corporation attractive to the seven institutions was their obtaining discount purchases of equity interests—that is, 150,000 common at \$1 per share, and rights to obtain between 200,000 and 307,692 common shares at between \$10 and \$6.50 per share, depending on where the stock (which was to go public at 26) would be selling three years later.

It is possible that the Schaefer family interests could have received maximum tax shelter by remaining private and by having borrowed funds flow into Brewing. Since the family owned 100 percent of Brewing, the funds might have been usable by them without any, or any appreciable, amounts being distributed to Arjayess or the four trusts. However, such a course of action could raise tax problems for Brewing, namely, a Section 531 problem on the unlawful retention of surplus, even though this probably would have been vitiated by Brewing's plans to spend at least \$38 million to construct a new facility in eastern Pennsylvania. In any event, we have no information about the amount of tax shelter available to Arjayess on its receipt of \$6 million. Also, it is probable that the four trusts have obtained more tax shelter from returns on their investments than would have been feasible if the same funds had been invested in Brewing. There is no question that with the considerable planning that went into the transactions, they were designed so that the combined tax impacts on Arjayess and the four trusts were minimized.

Had Brewing chosen to sell out to a larger company, it is extremely unlikely that the Schaefer family interests could have retained the same type of control over Brewing that became available to them through the creation of Corporation, which alone may have discouraged this approach. In

addition, it probably was difficult to find an acquirer with whom an agreement could be reached that would result in the Schaefer family interests' receiving \$86 million in cash (either from the acquirer's treasury or from the sale of shares received), plus a meaningful equity interest in the common stock of the acquiring company. It is possible, but not probable, that an acquirer with a usable tax-loss carryforward might pay out that much cash for Brewing (for example, see the Northwest Industries acquisition of Buckingham Corporation in 1971). If the Schaefer interests were to receive \$86 million cash either directly from the acquirer or through the sale of common stock of the acquirer received, the acquiring company in all probability would have had to account for the Brewing acquisition on a purchase basis rather than a pooling-of-interests basis. In addition, the sale of Brewing to a larger company could easily have been stopped or made difficult because of antitrust proceedings of the U.S. Department of Justice or the Federal Trade Commission.

Had Brewing remained as it was, a private, relatively debt-free corporation, there would have been no large-scale cash distributions to Arjayess or the four trusts. In addition, assuming there was no intention to ever go public, Brewing's business might have suffered because of the difficulty of offering key personnel meaningful equity interests in the enterprise.

On balance, the transaction that did take place did have many advantages for the Schaefer family interests. This does not mean that there were not a considerable number of disadvantages that ensued. First, the Schaefers were now in control of a highly leveraged public company with new sets of obligations to important outside interest groups. The seven institutional investors placed restrictions on operations and financing in accordance with the terms of the various purchase agreements. Both Corporation and the Schaefers were now subject to SEC requirements as to reporting and corporate conduct.

Also, lawyers representing minority interests would be very ready and able to seek redress for what they believed were wrongs to stockholders. If Brewing had remained closely held and if the Schaefer family interests desired to acquire for themselves, say, a beer distributor, there would have been no need to offer this distributor first to Brewing; however, as a public entity, Corporation would find that such a transaction would be extremely suspect, and quite possibly impossible to do as a practical matter.

Furthermore, as a result of going public, corporate objectives changed. As a private company, Brewing would strive to maximize economic profits, whereas, as a public entity, Corporation tends to strive to maximize immediate accounting profits. Frequently, the maximization of economic profits is in direct conflict with the maximization of immediate accounting profits. As a private company, Brewing would take as much depreciation as it could in order to reduce income taxes and accounting profits, and Brewing would be more willing to launch expensive programs—say, very large-scale advertising—the benefits of which may not be apparent for many years.

The Schaefer family interests were left with a large ownership interest in and control of a financially weakened company that was not as well prepared to meet competitive onslaughts as it might otherwise have been. As a matter of fact, in the early 1970s the principal national companies, Anheuser-Busch, Schlitz, and Miller's, commenced raiding regional markets with programs consisting of price-cutting and other forms of aggressive merchandising. Such programs were relatively successful for the nationals. Corporation's accounting earnings per share peaked at \$2.30 in 1970 and declined to \$1.75 in 1971. Corporation suffered a deficit of in excess of \$1 million in 1972, and deficit operations continued through 1973. The business was nominally profitable in 1974, 1976, and 1977, reported a massive deficit in 1975, and suffered a large loss in 1978.

Although the Schaefer family interests did create a large market value for their holdings in Corporation, such value was not readily realizable. Unlike the outside stockholders' shares, shares in Corporation held by the Schaefers were "tainted"—that is, they were not freely salable. As a practical matter, sales of large amounts of stock by them probably could only be accomplished by having another registered secondary or by selling the shares privately at a very substantial discount from market. A registered secondary might be accomplishable only via an underwriting, the cost of which might run from 7 to 10 percent of the gross proceeds, and at that, might be accomplishable only during periods when both the new-issue market was doing well and Corporation itself was prospering.

Brewing's Executive Employees

Two principal changes occurred for Brewing's executive employees. First, they received a new financial incentive in the form of discount purchases of Corporation stock, which theoretically could be disposed of by public sale in whole or in part at some future date. Second, Brewing's executive employees were now managing a consolidated enterprise that was heavily in debt and publicly owned, rather than a private company with excess financial resources.

The discount purchases by these executives were of two types. The first was the aggregate of 5,000 shares of Corporation common purchased at \$1 per share by five members of Brewing's executive management committee two months before Brewing went public at 26. On a gross valuation basis, this transaction resulted in a windfall of \$25 per share, or \$25,000 for each of the five individuals. Such a calculation, though, would be misleading. The reasons why the difference between a \$1 purchase price and a \$26 market price was something less than \$25 can be summarized as follows:

1. The \$1 price was a cash cost, whereas the \$26 market value was not a value these executives could realize in cash, either by selling the stock or by using it as collateral for loans. In this sense—that is, as measured by ability to realize cash—the shares could be deemed to have a value of \$26 only if they were registered with the SEC and if they were held beneficially by outsiders, not insiders. These are strictures that could adversely affect value even in the absence of specific contractual restrictions.
2. At the time of purchase, there was no assurance that Corporation could go public at all, or if it could, at what price it would go public. Value should have been adjusted to provide an estimate for this uncertainty.
3. The \$1 shares were acquired subject to specific contractual restrictions. Each executive agreed to resell the shares to Corporation at \$1 per share in the event he left Brewing before January 1, 1974, except in the case of death, disability, or approved retirement. After January 1, 1974, only 20 percent of the shares became free of their contractual restrictions per year cumulatively.

By having the opportunity to purchase Corporation shares at \$1 per, the five executives did receive something of value, although for income-tax purposes this was not construed to be a discount or bargain purchase. The reasons why the purchase was not so construed was that based on what the tangibles were in Corporation's business on September 20, 1968 (the purchase date), the shares were not even worth \$1. Also, others also paid the same price at that time. Had IRS considered the shares a bargain purchase, these executives would have had to treat the difference between the fair value of the shares received (26, for tax purposes) and the \$1 per-share cost as employment compensation to be taxed at ordinary income rates. If that had been the case, it is very probable some or all of the executives would have considered the right to buy shares at \$1 per share on September 20, 1968, as something with a negative value.

Also, these five executives received, in the form of equity ownership incentive, qualified stock options as part of a program under which designated employees, including certain officers and directors of Brewing, received options to purchase 98,134 Corporation common at 26. The options were granted at fair market value (26 per share) on the date the underwriting agreement was signed. These options were to expire five years from the date of grant or earlier in the event of termination of employment, disability, or death. In the case of some of the options, if they were not exercised during the first four years after grant, the exercise price could be payable by borrowing 90 percent of the required funds from Corporation. Such borrowings would bear interest at 4 percent, and the notes would be repayable at the rate of 20 percent per year. Put simply, these qualified options permitted the holders' potential profit, on a tax-sheltered basis, from appreciation in Corporation's stock price, without any cash outlay at all for five years and with very attractive financing terms for the next five years.

The tax shelter existed because the options were, for IRS purposes, “qualified.” If the employees had received nonqualified or nonstatutory stock options, then the excess of the fair value of those options over their cost would, in the majority of cases and unless carefully structured, be taxable as employee compensation in the year of receipt. The worst tax posture a taxpayer can find himself in would result from such a nonstatutory stock option.

As the operating heads of Brewing and its parent, Corporation, the officers and directors of the public company now found themselves influenced by a different discipline from when they were officers and directors of a private company with excess financial resources. The different discipline was not necessarily better or worse, but it was different.

1. In a public company, all other things being equal, there is a tendency toward more aggressiveness in striving for near-term results and less emphasis on long-range planning, especially if such long-range planning might adversely affect near-term profits. For example, there might be less institutional advertising.

2. In a public company, there is a tendency toward making reported results as good as possible, even though it would make actual economic results worse than they ought to be. For example, the Corporation-Brewing transaction could have been structured so that depreciation charges against income would have been based on Corporation's purchase price for Brewing, \$106 million, rather than on Brewing's net asset value, \$53 million. The tax savings would have been highly significant. However, if that had been done, Corporation's reported earnings from 1969 forward would have been substantially lower, with consequent possible adverse effects on stock market valuations. For public companies, stock market consciousness frequently takes precedence over tax consciousness and underlying business value consciousness. In private companies, the question usually never arises; the private company will opt for maximum tax savings.

3. With the public as partners, Corporation's and Brewing's executives, as well as the corporation itself, became subject to a whole gamut of new disciplines in terms of what they were required to disclose in the way of information and the liabilities to which they became subject, both to government authorities and stockholders, because they were public.

4. Managements with public stock to use tend to be more conscious of values that can be created by using the stock, especially when it is selling at a liberal price. This, for example, manifests itself in certain public companies having active merger, acquisition, and refinancing programs.

The Commercial Bank Providing Bridge Financing

First National City Bank provided \$24.9 million of loans to Corporation with interest at the prime rate. In addition, the bank received a commitment, or standby, fee equal to an annual rate of $\frac{1}{8}$ percent of the unused balance (that is, the portion of the \$24.9 million not borrowed) from September 26, 1968, to the closing or December 31, 1968, whichever was earlier. Subsequently, the commitment fee on the unused balance was increased to $\frac{1}{4}$ percent. These loans, in the form of short-term notes, were issued in July 1969 and were retired within one year as the seven institutions invested their funds into Corporation in the form of long-term senior notes and subordinated notes. Corporation did have the right to prepay the bank loan at any time, but would have incurred a $\frac{1}{4}$ percent prepayment penalty if it used funds obtained by borrowings at a lower

interest cost than First National City's prime rate.

From the bank's point of view, the loan in the form of bridge financing seemed reasonably safe. First, there was the take-out by the permanent lenders, the seven institutions who were committed to invest further sums on January 15, 1970, and July 15, 1970, the first proceeds of which were to be used to repay these short-term notes. Second, Corporation consolidated with Brewing was a profitable, growing business with operating earnings in excess of \$1 million per month, a substantial balance-sheet cushion behind these notes in the form of about \$12 million of subordinated notes, \$20 million of junior subordinated notes and a stockholder's equity (including over \$50 million of nonamortizing good will) of about \$37 million. Also, Corporation was managed by a highly reputable and successful group.

Returns to the bank exceeded merely interest at the prime rate. The loan itself probably required compensating balances of 10 percent to 20 percent of the notes outstanding to be kept on deposit. First National City may also have become the bank of deposit, as well as the lending bank, in connection with other Corporation activities, and the transactions may have resulted in creating trust business for the bank. As far as corporate trust activities are concerned, First National City did become the registrar for Corporation common. As far as personal trust is concerned, First National City could conceivably have obtained investment management and/or custodian business from the Schaefer family in connection with the handling of their portfolios.

Although the financing of acquisitions is attractive, banks view it as the least productive part of their lending activities. These are virtually the first loans to be cut out in periods when money is tight or generally unavailable, as in 1966, from 1969 to 1970, and again in 1973 and 1974 and 2008–2009.

The Wall Street Promoters

Pressprich, then a prestigious New York Stock Exchange member firm, appeared to have profited handsomely from the transaction under which Corporation purchased Brewing's equity securities simultaneously with Corporation's going public. Off the top, Pressprich received fees of \$425,000 for arranging Corporation's financing; and for \$.42 per share, or a total of about \$67,000, Pressprich purchased 160,000 common five months before the public subscribed to freely tradable shares of the same issue at 26 per share (equal to \$4,160,000 for 160,000 shares). The 160,000 common held by Pressprich were, for SEC purposes, unregistered, or restricted, shares; in any event, Pressprich had agreed with Corporation not to sell the shares to anyone before March 15, 1971, without first offering the shares to Corporation at \$.42 per share. Even with these restrictions on resale, the 160,000 share acquisition seemed to have been quite a bargain for Pressprich from any point of view except that of the Internal Revenue Service.

Less visible and less tangible were other benefits to Pressprich. First, the firm gained two seats on Corporation's board of directors, which probably resulted in small fees and elements of control over important assets. "Control," a many-faceted concept, could extend, for example, to having Pressprich's directors influence the company in registering shares for distribution with the SEC, including the 160,000 shares held by Pressprich. In the normal situation, however, the Pressprich directors would be outside directors, and their *de facto* control over the affairs of Corporation would be manifestly less than would the inside directors' and management members', whether directors or not. The liabilities of the outside directors, however, could easily be just as large as anyone else's in the case of judicial or administrative findings of wrongdoing that harmed Corporation or its stockholders. (This is why many people are reluctant to serve on boards, especially since neither corporate indemnification provisions nor directors' liability insurance can give a director assured insulation from liabilities. Yet, on balance, most people probably feel there is a net benefit to them and to their organization from serving as outside directors on the boards of public corporations.)

Another benefit that may well have been available to Pressprich was future business from happy clients. The happy clients were of two types, both of whom had enormous amounts of investible funds (the sort of clients that investment bankers and stockbrokers like Pressprich like best). The first set of clients were the shareholders of Brewing who received \$86 million in cash, namely, the corporation controlled by Rudolph Schaefer, Arjayess, and the four trusts for the

benefit of various members of the Schaefer family. The second set of happy clients were the seven institutions that purchased corporation senior and subordinated notes with equity privileges, which by themselves seemed a reasonable investment. These institutions also split amongst themselves 150,000 shares of Corporation common purchased for \$1 per share.

Finally, the successful completion of Corporation's public underwriting and subsequent favorable market action for Corporation stock unquestionably enhanced Pressprich's reputation, both within the financial community and with others of means who were seeking the creative finance that the Schaefer case had demonstrated. The success of the transactions, therefore, could easily result in Pressprich's gaining access to much more new investment banking business unrelated to the Schaefer transactions than would have been the case had Pressprich not concluded successfully the Schaefer deal.

One footnote is that Pressprich was a member of the National Association of Securities Dealers, commonly known as the NASD. All New York Stock Exchange member firms are also NASD members. The new (since 1970) NASD Rules of Fair Practice that relate to corporate financing would have prevented Pressprich from doing what it did in 1968. First, Pressprich would have had to have held its \$.42 stock for at least six months and in all probability one year before Corporation could have gone public. If it did not, the NASD probably would rule under current regulations that the \$.42 purchase price was integrated with the \$26 public offering and resulted in Pressprich receiving unreasonable compensation. Also, if the transactions were to be undertaken now, it is quite possible that the NASD would rule that Pressprich's purchase of stock would be limited to 10 percent of the public offering. The Corporation public offering was for 1.5 million shares, which would limit Pressprich's prior purchase to 150,000 shares.

In any event, Pressprich's discount purchase of 160,000 shares appears to have been perfectly legitimate in 1968 and was certainly not then an uncommon transaction within the investment community.

The Underwriters of the Public Issue and Their Securities Salesmen

When Pressprich became involved with the Corporation-Brewing transactions, it was contemplated that R. W. Pressprich and Company would manage the underwriting of 1 million Corporation common at around 26, which later increased to 1.5 million shares. In fact, when the preliminary registration statement was filed with the Securities and Exchange Commission on September 26, 1968, R. W. Pressprich and Company was listed as the managing underwriter.

We do not know the reasons why White, Weld and Company was substituted as managing underwriter for Pressprich, and why Pressprich was not a member of the Corporation's underwriting group in any capacity when the 1.5 million shares were marketed on November 27, 1968. The probabilities are that the National Association of Securities Dealers, under its Rules of Fair Practice as they then existed, frowned on Pressprich or any Pressprich affiliate participating in the Corporation underwriting, because only a few months previously Pressprich had purchased 160,000 shares at \$.42 per share. When the preliminary registration statement was filed with the SEC, the maximum filing price was 26.

The switch from Pressprich to White, Weld brings to light three important points. First, in putting together complex transactions, things rarely, if ever, go smoothly, and all sorts of changes are usually made in midstream. Second, it is likely that the part of the compensation to Pressprich consisting of financial fees and bargain purchases of Corporation stock were in economic fact payments for arranging the public underwriting.

Third, it would appear as if White, Weld, as managing underwriter, was undercompensated, compared with what was received by certain other insiders and quasi-insiders, namely the selling stockholders, Pressprich and the lending institutions. After all, the achievement of the public distribution and the raising of over \$30 million was a *sine qua non*. Yet, White, Weld purchased no discount stock and received no special fees: it participated only in its share of the underwriting spread, or discount, of \$1.56 per share, or \$2,340,000.

Under the NASD Rules of Fair Practice, as well as in connection with certain blue sky laws, it

may have been inappropriate for the underwriters to seek materially greater amounts of compensation. Even so, the transaction probably was a reasonably profitable one from White, Weld's point of view. White, Weld obtained by far the largest participation in the underwriting, 218,000 shares, or 14.5 percent of the 1.5-million-share issue. The next-largest participation for a firm in the underwriting group was 33,000 shares, taken down by Dillon, Read and Kuhn, Loeb. The next-lowest bracket was 22,000 shares, and firms participating at this level were Halsey, Stuart; Kidder, Peabody; Lazard Freres; Lehman Brothers; Paine, Webber, Jackson and Curtis; Paribas; Shields; Stone and Webster Securities; and G. H. Walker. Since the issue was in demand, these underwriters and their sales forces were able to realize their allotted compensation both for performing the underwriting function and as selected dealers.

Compensation to White, Weld, other underwriters and members of the selling group, most or all of whom were also underwriters, was spelled out in three agreements that had been prepared previously but that were executed on November 26, 1968, the day the offering was declared effective by the SEC and the day before the actual offering. The first agreement was the Underwriting Agreement (sometimes called the Purchase Agreement), entered into between White, Weld and Corporation. The second agreement was the Agreement Among Underwriters (sometimes simply called the Agreement Among) between White, Weld as representative of all the underwriters and each individual firm that became a party to the underwriting. The third agreement was the Selected Dealer Agreement between White, Weld as representative of the underwriter and each selected dealer.

The Underwriting Agreement spelled out in specifics the various terms between White, Weld and Corporation, including the representations and warranties each gave to the other, the conditions of closing, indemnifications, and so on. Briefly, Corporation agreed to sell to each of the underwriters, and each of the underwriters agreed to purchase, the specified number of Corporation shares allotted to them (218,000 for White, Weld) at \$24.44 per share. Payment was to be made to Corporation on December 4, 1968, one week after the offering, but in no event more than eight business days after December 4.

The Agreement Among as well as the Selected Dealer Agreement gave White, Weld strong control over how the issue would be marketed and by whom. One of the matters in the Agreement Among was that the underwriters were to act severally, not jointly, so that default by one member of the group would not make all other members liable. In economic terms, the Agreement Among and the Selected Dealer Agreement outlined how the \$1.56 underwriting discount (the difference between the \$26 public offering price and the \$24.44 to be paid to Corporation) was to be split. In tabular form, the split was to be as shown in [Table 27.5](#).

Table 27.5 Composition of the Spread between What Corporation and Others Get

Payment for	To	Per Share	Total Amount
Management expenses (estimated)	White, Weld	\$0.31	\$265,000
Selected dealers who market shares	White, Weld ^(A) Selected dealers, all	\$0.05	\$75,000
	or		
	most of whom may be underwriters	\$0.85	\$1,275,000
Underwriting or syndicate function	Underwriters	<u>\$0.35</u>	<u>\$525,000</u>
		\$1.56	\$2,140,000
NASD members who market shares but are not selected dealers	NASD members who are not selected dealers (none will be underwriters)	Up to \$26 ^(B)	

(A) Estimated to cover expenses of underwriting. Charges for White, Weld expenses to the underwriting group.

(B) Payable out of \$.85 fee given to selected dealers.

The \$.85 concession to selected dealers is basically sales compensation, equal to about a triple commission over the standard New York Stock Exchange commission rates. The extra promotional consideration available to salesmen, some of whom might obtain close to 50 percent of the then \$.85, goes a long way toward explaining why the financial community has such a vested interest in promoting new-issue booms. It also explains why the securities laws are so written that the SEC tries to make its rules and laws on conditioning markets so much stricter when underwritings are involved.

Handling a good-grade hot issue such as Schaefer brought other benefits to White, Weld. First, it unquestionably brought profit contributions and overhead coverage to its underwriting department. Second, it benefited White, Weld's sales force by giving them attractive merchandise to sell and at rates that allowed them high compensation for an easy sell. Third, it enhanced White, Weld's ability to participate in underwritings managed by others: The odds are that because Kuhn, Loeb and Lehman were invited by White, Weld into important positions in Corporation's underwriting, Kuhn, Loeb and Lehman would be more desirous of inviting White, Weld into their underwriting groups for attractive issues than would otherwise have been the case. Also, in the event White, Weld was to find itself in the type of promotional position that Pressprich was in, in these transactions, Pressprich or others might be more sympathetic to managing an underwriting of a White, Weld deal than it would otherwise.

The Institutional Lenders Providing Long-Term Financing

The seven financial institutions had two reasons for investing \$65 million into Corporation's senior notes and subordinated notes. First and—at least in the case of the six insurance-company investors—foremost was the thesis that these were reasonably safe long-term loans affording a cash return in the form of interest income close to what good-grade bonds were then paying. Second, the seven institutions obtained very significant equity kickers in the form of the discount purchase of 150,000 common at \$1 and of warrants to purchase between 84,866 and 130,563 common at a price that could be 75 percent below the market price three years later; they also

gained the right to convert \$1,151,340 of subordinated notes into common stock at a price that could be 75 percent below the market price three years later (or \$6.50 a share).

It should be noted, however, that on conservative analysis the total \$65 million investment could at best be called only fairly safe. It was far from risk-free, since \$27,857,143 (or 42.9 percent) of the \$65 million commitment was in the form of subordinates. Thus, in the event Corporation suffered serious financial reverses, the subordinates could be junior in payment not only to these senior notes, but also to other senior notes that might be issued in the future. On an overall basis, these issues failed four of the seven safety tests promulgated by Graham and Dodd in *Security Analysis* (4th Edition, McGraw-Hill 1962). (Graham and Dodd advise forgoing investing in any senior security that ever fails one test.) Corporation's senior securities seemed to have qualified under the following three tests:

1. Nature and location of the business
2. Size of the enterprise
3. Terms of the issue

Tests where these \$65 million of securities were found wanting were

1. Record of solvency, at least insofar as Corporation was concerned, since it was a new entity operating under a new (that is, public) discipline
2. Relationship of earnings to interest requirements
3. Relationship of the value of the property to funded debt
4. Relationship of the stock capitalization to funded debt

Interestingly enough, Graham and Dodd do not have an eighth test, which may be the single most direct test of senior security safety—the relationship of cash flow to debt service, or the cash flow available to meet both interest and principal payments.

Although the institutional investors would hardly consider the \$65 million loans top drawer from a safety angle, they were good enough. The important aspect was the equity kicker. In appraising the equity kicker, the institutions looked at three things:

1. The discount from market at which they could obtain shares.
2. The appraisal of the outlook for the business, on the theory that the long-term price of the stock would tend to be related to the performance of the company (in this analysis, the institutions used many of the same variables that were used when appraising the safety of the loan).
3. The rights of registration that would permit the institutions to dispose of the shares.

Rights of registration were more important to the seven institutions than they were to the other purchasers of discount stock, namely, the selling stockholders, Brewing executives, and Pressprich. These purchasers were all represented on the board and might be in a position to influence the company to register the shares they held with the SEC. The seven institutions, in contrast, could only be assured of registration rights in contractual provisions.

Registration rights are extremely valuable to purchasers of unregistered discount securities, especially those who acquire large amounts of restricted securities. For those acquiring small blocks of restricted securities, the use of the SEC's Rule 144, in effect since April 15, 1972, is practical.

Just how valuable registration rights depends on the various contractual rights embodied in the agreements that relate to the stock market situation for the particular securities. The contractual provision can be quite diverse, ranging from very strong to almost meaningless. (Registration rights also encompass matters not discussed here but that are essentially legal, such as indemnification provisions and agreements to supply documentation.) We think the registration rights received by the seven institutional lenders were very strong. Briefly reviewed, the principal economic provisions of the registration rights to the institutional investors were as follows:

Effective date. The institutions' rights of registration became effective January 15, 1971, or about two years after the initial investment. Incidentally, Pressprich obtained registration rights that were different from the institutions' rights and that became effective March 15, 1971.

Expiration date. None.

Demand, or trigger, rights. This refers to the right of a security holder to require a company to file a registration statement enabling the beneficiaries of such registration rights to publicly offer their shares. The institution or institutions could make four such requests; Pressprich could make one.

Piggyback rights. This refers to rights to have holders' shares included in a registration statement filed by the company or by other selling stockholders. The institutions and Pressprich had unlimited rights in this regard. It is advantageous to be able to piggyback, but it frequently is disadvantageous to be piggybacked by others. For example, assume John Hancock and New York Life used a trigger right to register 75,000 shares for sale. Left alone, the 75,000 shares might be sold at or near the market price. However, the agreement would give all other holders of restricted securities the right to join in, or piggyback, any registration. The John Hancock and New York Life request to register 75,000 shares could easily result in, say, 530,000 shares being registered and sold. This could result in severely depressing the market price, or as a practical matter, making sale of John Hancock's and New York Life's 75,000 shares unachievable.

Number of times registration can be requested. In the institution's case, it was four for trigger (one for Pressprich), unlimited for piggyback.

Expenses. With minor exceptions, expenses were to be borne by Corporation.

Requirement that registration be underwritten. None.

Obligation of company to keep registration effective after nine months. Yes.

The Public Investors

Those of the investing public who were fortunate enough to get in on a new hot issue at the time of the initial offering paid 26 per share for Corporation common on November 27, 1968. Pressprich had paid \$.42 per share five months before for Corporation common, and others had paid \$1 per share just two months before. And the public stood in line for the privilege!

The Corporation common stock bought by the public was not, in economic fact, the same Corporation common purchased by insiders and quasi-insiders. For one thing, any public shareholder was free to dispose of his shares at any time. Indeed, any public purchaser who obtained his shares on the initial offering could have disposed of his stock at a profit at any time from the afternoon of the offering through April 1971, a period of almost 30 months. The purchasers of discount-priced securities, however, were prevented from selling any stock before January 1971 at the earliest. In each instance, the purchasers of discount securities were subject to a number of constraints or were required to perform special services; the public investors, though, were purely passive and assumed no obligations. This is not to say that the public received a highly advantageous position compared with the Schaefer family, Brewing executives, Pressprich, or the institutional lenders; that would be silly. It is to say that the public investors were marching, or do march, to the beat of a different drummer from the promoters' and insiders'. As a

consequence, by the standards used by the public the \$26 issue price was a bargain.

The public in 1968 tended to be uninterested in things that contributed to value if they did not also contribute to market performance. The public stockholders acquiring Corporation common stock sought, above all, immediate stock market performance. New issues such as Corporation's offering gave great promise in 1968 of immediate performance for the following reasons:

1. Underwriters consciously try to price new issues so that they will sell at premiums after the offering. Normally, the strongest determinant of a market price will be industry identification as it relates to earnings, especially earnings trends. In pricing Corporation common where the earnings trend was favorable, the underwriters appeared to have attached to Schaefer a price-earnings (P/E) ratio moderately below that at which other brewing equities with favorable operating trends were selling.
2. Good market performance is more likely to occur when an issue is well sponsored. Corporation's bankers and promoters were well regarded; its underwriting group was top drawer; investors in the company's common stock included very astute names, such as John Hancock, Investors Syndicates, and New York Life; and the issue was to be listed on the New York Stock Exchange.
3. Securities salesmen love to push new issues. A rule of thumb in 1968 was that salesmen's compensation for placing a new issue should be about three times the then standard New York Stock Exchange commission for an order of similar size. Sales forces tend to talk up new issues, if for no other reason than that they are very interested in them. This contributes to creating instant performance.

It would have been difficult, if not impossible, to have Brewing or Corporation go public via an offering if the business was not one with a favorable industry identification and a "growth story." In 1968, virtually all the companies in the new-issue boom had growth-industry identifications in areas such as computers, electronics, franchises, and nursing homes. There were little or no sales of common stocks of companies going public for the first time in industries such as railroads, textiles, or general-line fire and casualty insurance.

Yet there are things other than positive industry identification and growth prospects that contribute to value. For example, in Brewing itself one of the great elements of value to others than the public was the fact that Brewing had unused financial resources; this was one of the bases giving Corporation the ability to borrow \$65 million from the seven institutions. Other elements of value that the public would not normally consider include usable tax-loss carryforwards (or better yet, creatable tax losses) in companies unencumbered by other obligations, and large asset values, whether reflected in accounting figures or not.

In fact, the trick in underwriting is that if an equity security is discount-priced based on business standards, it probably cannot be underwritten. The public that buys new common-stock issues tends to want instant performance, which cannot be gotten out of an issue that is not susceptible to being made popular. If an issue is popular, it is unlikely to be discount-priced based on business standards. However, once an issue has an identification that makes it susceptible to popularization, the underwriter will (a) popularize it and (b) try to price it at a discount based solely on stock market standards—that is, it will be priced at a P/E ratio moderately below the P/E ratio at which the stocks of similar companies that are already public sell.

In giving the public a discount in new issues based on stock market standards, the underwriter tends to be moderate, not gross in his relative underpricing. The public, after all, tends to buy new-issue sizzles, not steaks, in the form of ephemerals (sponsorship, P/E ratios, growth, and so on) that they believe should contribute to immediate performance. Purchases are not based on any fundamental bedrock of real knowledge about the business. Thus, suspicions are easily aroused. Too low a price—say, offering Corporation stock at 10 times earnings when Anheuser-Busch is

selling at 20 times earnings—would detract from the salability of the Corporation common-stock issue, whereas an offering at 16 times earnings probably would contribute to it.

The New Public Company

As mentioned previously, the Brewing operation has been transformed into a new one with a different discipline—not better or worse, but different. The differences are outlined in [Table 27.6](#).

Table 27.6 Transformation of Old Brewing into a Different Discipline

New Corporation	Old Brewing
Heavy debt load	Excess financial resources
More attuned to immediate results	
Requirements for public obligations including filings	
A common stock usable for employee incentives	
A common stock usable for acquisitions	
Emphasizes AFF—accounting fudge factor—reported earnings. (Especially pronounced is failure to write up assets to reflect Corporation’s \$106 million purchase price for Brewing’s equity securities.)	Emphasis on tax shelter

SUMMARY

Deals are not like a chess game, where by definition if one side wins, the other loses; they are not zero sum. A well-structured deal has something in it for everyone. Few readers of or writers on finance will ever be involved in the design and architecture of a deal of the dimensions described here. But an understanding and appreciation of its structure should help to provide some insights into the realities of a world of finance rarely seen but always present.

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¹ One indication that Brewing’s accounting practices were conservative was that Brewing,

which was charging over \$4 million per year against the income accounts for depreciation, used the same depreciation methods (the 200 percent, double-declining-balance method) for book purposes as it did for tax purposes. Nor does the fact that Brewing *flowed through* investment credits, which amounted to \$275,000 in 1967, indicate otherwise; the amount involved was small, particularly compared with depreciation charges. The company's five-year statements had been audited by Price Waterhouse and Company, and certified clean.

² Brewing had plans to construct a new 1.7-million-barrel facility in eastern Pennsylvania. The initial phase of the Pennsylvania construction was to provide an 850,000-barrel annual capacity at an estimated cost of approximately \$38 million, or \$44.71 per barrel, some five times as much as the net book value of existing plant. Even assuming that the remainder of the proposed Pennsylvania plant could be built for a relatively small sum, the total cost was unlikely to be less than \$25 per barrel, or some three times the net book carrying value of the existing plant. Notwithstanding any other factors, such as labor-saving innovations and other efficiencies in new plants, Brewing's property, plant, and equipment do not seem to have been overvalued on the books.

³ Parenthetically, restricted shares issued after the passage of Rule 144 in April 1972 could only be sold publicly pursuant to that rule or via registration. No action letters and change-of-circumstances opinions no longer existed in such cases. From 1972 until late 1978, when resale restrictions were liberalized, sales under Rule 144 could occur only once every six months, and the number of shares that could be sold was limited to the lesser of 1 percent of the outstanding stock of the company, or the weekly average traded for the four weeks preceding the filing of a Form 144.

⁴ The other members of Corporation's twelve-man board of directors were three Schaefer family members, three executives of Brewing, two executives of Pressprich, and two outside directors—the chief executive officer of United Aircraft and a vice-chairman of the board of the First National City Bank.

⁵ Corporation also entered into an agreement with First National City on November 25, 1968, under which the bank would provide any interim funds that might be needed to meet the payments due the four Schaefer trusts by July 15, 1969. This was estimated at under \$25 million.

⁶ In some instances, warrants can be exercised by the surrender of senior securities valued, for purposes of exercise, at par. If the senior security has a market value of less than par, then the senior-security-warrant package becomes the equivalent of a convertible security.

⁷ This phenomenon reached its peak in recent years with the debt restructuring of a number of troubled real estate investment trusts. In certain instances, such as Chase Manhattan Mortgage and Realty Trust, senior lenders even invested new funds in the real estate investment trusts, part of which were in fact used to continue to fully service the subordinated debentures.

⁸ At year-end, its price was 30 bid. Corporation's stock was listed for trading on the New York Stock Exchange on January 24, 1969.

⁹ This gross spread was about standard for a fairly large new-issue offering of an industrial issuer going public. Although there have been new issues of common stock marketed at a smaller gross spread when a company was going public (most notably Communications Satellite Corporation, or Comsat, whose gross spread was 4 percent when it went public in 1965), this is unusual. Smaller, unseasoned issuers call for higher gross spreads, frequently as high as 18 percent, exclusive of other considerations—such as continued financial consulting fees, board representation, and rights of first refusal on future company offerings—granted to the underwriter.

¹⁰ This sales commission of \$0.85, or \$85 per 100 shares, was considerably higher than \$0.32 per share or \$32 per 100 shares selling at 26, the standard commission prevailing in 1968 for round lots (usually 100 shares) of outstanding stock listed on the New York Stock Exchange.

Glossary of Acronyms

AF	Accounting fudge factor
APT	Arbitrage pricing theory
AM	Assets under management
BAFCPA	Bankruptcy Abuse Prevention and Consumer Protection Act of 2005
BPS	Book points
CAPM	Capital asset pricing theory
DCF	Discounted cash flows
DE	Debtor in possession
EPT	Efficient portfolio theory
E&P	Exchange and purchase agreement
E&P	Exploration and production
EBITDA	Earnings before interest, income taxes, depreciation and amortization
EMH	Efficient market theory
EPS	Earnings per share
EV	Enterprise value
EVA	Economic Value Added
FASB	Financial Accounting Standards Board
FF	Fundamental finance
FINRA	Financial Industry Regulatory Authority
GD	Graham, Dodd, and Cottle. Refers to their book <i>Security Analysis: Principles and Technique</i> , 4th Edition (McGraw Hill 1962)
GAAP	Generally Accepted Accounting Principles
GARP	Growth at dirt-cheap prices
GDP	Growth at reasonable prices
GDP	Gross domestic product
GP	General partner
IFRS	International Financial Reporting Standards
IPC	Initial public offering
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IRR	Internal rate of return
LB	Leveraged Buyout
LP	Limited partner
LT	Twelve months
M&A	Mergers and acquisitions
MB	Management buyout
MCT	Modern capital theory
NAV	Net asset value

NIet income
NPVpresent value
NTMtwelve months
OPMor people's money
OPMIide passive minority investor
PEice earnings ratio
PEGce earnings to growth ratio
PFIive foreign investment companies
PGomoter group
PIIGSgal, Ireland, Italy, Greece and Spain
PITAin the ass investing
PLAN of reorganization
PPMate placement memorandum
PRublic relations
REITestate investment trust
ROArn on assets
ROErn on equity
ROIrn on investment
RSAerve recognition accounting
SBAall Business Administration
SECurities and Exchange Commission
SOMEthing off the top
TARPbled Asset Relief Program
TIAst Indenture Act of 1939
TSx shelter
YTM to maturity

About the Authors

MARTIN J. WHITMAN, CFA

Regarded as the Dean of Value Investing, Martin J. Whitman has proven an effective value investor in common stocks and an adept control investor who has led the rehabilitations of companies in various industries over the past five decades.

After serving in the U. S. Navy during World War II and attending Syracuse University and Graduate School at Princeton University on the G.I. Bill, Mr. Whitman joined the ranks of Wall Street as an analyst at Shearson Hammill & Co. Later, while working at the family office of William Rosenwald, son of a founder of Sears Roebuck, he developed a risk aversion commensurate with the responsibility of managing another family's legacy. His ability to find safety through the careful study of assets enabled him to venture where other investors would not, like the bankrupt Penn Central Railroad secured debt or the mortgage debt of troubled utilities, such as General Public Utilities and the Public Service Company of New Hampshire.

Mr. Whitman founded his own brokerage firm in 1974 and the predecessor to the Third Avenue Funds in 1986. He managed the flagship Third Avenue Value Fund from its inception in 1990 through 2012 and was Third Avenue's Chief Investment Officer from its founding through January 2010. He continues to work closely with Third Avenue's investment team.

For over 30 years, Mr. Whitman was a Distinguished Management Fellow at the Yale School of Management. He frequently teaches at Syracuse University and Columbia University. He is also an honorary trustee of Syracuse University, his undergraduate *alma mater* and home to the Whitman School of Management, which is named in his honor. He is the author of *The Aggressive Conservative Investor* (Wiley Investment Classics, 2005), *Value Investing: A Balanced Approach* (John Wiley & Sons, 1999) and co-author of *Distress Investing: Principles and Technique* (John Wiley & Sons, 2009). He holds a master's degree in Economics from The New School and is a *magna cum laude* Syracuse graduate. Mr. Whitman is a board member at Tel Aviv University's Institute for National Security Studies.

FERNANDO DIZ, PHD

Dr. Diz is the Managing Director of The Orange Value Fund, LLC, a fund whose guiding investing philosophy is "safe and cheap." He is also the Martin J. Whitman Professor of Finance and the Director of the Ballentine Investment Institute at Syracuse University's Whitman School of Management. After obtaining his doctorate from Cornell University in 1989, Dr. Diz worked and did research in the derivatives area, became a commodity trading advisor, and founded M&E Financial Markets Research, LLC where he managed a futures portfolio until the mid-1990s. He has been working with Mr. Whitman since he first met him two decades ago. With Mr. Whitman's help, he created the Distress Investing Seminar, now in its tenth year of operation, and in 2006 he developed the academic content for the two-year undergraduate Value Investing program. He is the co-author of *Distress Investing: Principles and Technique*, a book that is the outcome of Dr. Diz' and Mr. Whitman's collaboration in co-teaching the Distress Investing Seminars.

Professor Diz's research has appeared in many academic journals as well as in industry publications including the *Review of Financial Studies*, *The Journal of Futures Markets*, *Managed Account Reports (MAR)*, *Barclay Managed Futures Report*, *Energy in the News*, *Metals in the News*, *Futures Magazine*, *The Journal of Bankruptcy Practice*, and others. Dr. Diz has consulted with the

Independent Consultants to UBS and Bear Stearns under the SEC Global Settlement and with many other companies including New York State Electric and Gas, El Paso Power Services, Citizens Power, Connectiv, Agway Energy, Niagara Mohawk Power Corporation, Barclay Trading Group, Caixa Catalunya, and MEFF.

Professor Diz teaches Value, Control, and Distress Investing classes that he developed with the guidance and counsel of Mr. Whitman, and directs the Value Investing program at Syracuse University.

Index

A

Activists
AECOM Technology Corp.
AIG
Albemarle Paper Manufacturing Company
Alcoa, Inc.
Alienability
Ally Bank
Ambase
Amerada Petroleum
American Chain and Cable Company
American Express Company
APB 25
Apple, Inc.
Applied Materials
Assets, composition and characteristics of
AT&T

B

Babcock International
Bailouts
Baker Fentress
Bank of America Corporation
Bankruptcy, prepackaged or preplanned
Barber Oil Company
Bear Stearns
Benson and Hedges
Berkshire Hathaway
Blue sky statutes
Boeing Company
Boston Celtics, L.P., IPO of
Broadcom Corp.
Broker-dealer research departments and conventional money managers
 how they think
 problems faced by
 analyses that focus on base case forecasts
 approach antithetical to those used by private
 businesspeople and control buyers

external pressures

forecasting earnings

conventional analysis

lack of awareness of relationship between income account numbers and balance sheet numbers and analytic

conflicts between related numbers

lack of balanced focus

operating ratios based on financial accounting statistics, concentrating on

predicting future earnings while ignoring existing balance sheet

reliance on fieldwork

reliance on perceptions of what others think

top-down analysis

Brookfield Asset Management

Buffett, Warren

C

Capital markets, access to

Capital Southwest Corporation

Capital structure

conservative

from the corporate perspective

constituency conflicts with corporate feasibility

constituency stakes in corporate feasibility

dividend policy

equity markets, accessing

resource conversion, capitalization in

retained earnings, financing with

substantive consolidation

factors affecting

assets, composition and characteristics of

creditors, needs and desires of

custom and usage

investment bankers, attorneys, and accountants,

professional advice of
managements and control groups, needs, desires, and
proclivities of
OPMIs and their representatives, needs and desires of
rating agencies, needs and desires of
regulators, needs and desires of

Capital Southwest Corporation

annual per share NAV, growth rate, per share market price and premium (discount) to NAV

Capitalism and Freedom (Friedman)

Carlyle Group

Cash dividends

roles of, in security analysis and portfolio management

and bailouts

conventional theories

as a factor in market performance

and legal lists

placebo effect of

and portfolio management

securities holders, goals of

Caterpillar Inc.

Cerberus, L.P.

Chapter 11 filing

Cheung Kong Holdings Limited

annual per share NAV, growth rate, per share market price and premium (discount) to NAV

Chevron Corporation

Chrysler

Chapter 11 reorganization of

Cisco Systems, Inc.

CIT Corporation

Chapter 11 reorganization of

Citigroup

Citizens Utilities

Clayton Dubilier and Rice (CDR)

Coca-Cola Company

Common stock

methods for acquisition of

cash mergers through use of proxy machinery

cash-tender offers

open market, cash purchases in

private transactions, cash purchases in

prices, influence of reported earnings on

Company disclosures and information

documents

paper trail

U.S., narrative disclosures in

freewheeling

sources

stereotypical filings with SEC

Control, importance of

Controlling stockholders, use of creative finance to benefit

Schaefer Corporation

Corporate feasibility

constituency conflicts with

constituency stakes in

Corporate Financial Reporting in a Competitive Economy (Bevis)

Corporate takeover, use of creative finance in

Leasco Data Processing Company

Corporation Finance (Ross, Westerfield, & Jaffe)

Corroon & Black

“The Cost of Capital, Corporation Finance and the Theory of Investment” (Modigliani & Miller)

Countrywide Financial Corp.

Creditworthiness

from the borrowing entity point of view

capital structure

from the corporate perspective

factors affecting

D

DCF. *See* Discounted cash flow

Delaware Block valuation methodology

Discounted cash flow (DCF)

Distress investing

five basic truths of

Dividend policy

Dividends

cash

roles of, in security analysis and portfolio management

stock

Diversification

corporate vs. concentration

portfolio vs. securities concentration

Dodd, David

view on NAV

Duplan Corporation

E

E. I. du Pont de Nemours and Company
Earnings record, long-term
Efficient market hypothesis (EMH)
Eljer Industries Secured Bank Debt
EMH. *See* Efficient market hypothesis
Enron
Enterprise value (EV)
Equilibrium pricing
Equity markets, accessing
Ernst & Ernst v. Hochfelder
Eurozone crisis resolution
Exxon Mobil Corporation

F

Facebook, Inc.
Fannie Mae
FASB 123
Financial accounting, uses and limitations of
 conventional approaches
 GAAP as defining reality for certain specific purposes
 GAAP as road map for due-diligence and less thorough investigations
 reports as objective benchmarks
Financial Institutions Regulatory Authority (FINRA)
Fitch Ratings
Forest City Enterprises
Freddie Mac
Friedman, Milton
Funds under management, selected companies (2011 year-end)

G

GAAP. *See* Generally accepted accounting principles
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Galbraith, John K.
G&D (Graham and Dodd). *See* Graham, Benjamin; Dodd, David
General Electric Company
General Motors (GM)
 Chapter 11 reorganization of
General Motors Acceptance Corporation (GMAC)
Generally accepted accounting principles (GAAP)
 as defining reality for certain specific purposes
 as road map for due-diligence and less thorough investigations
Georgia-Pacific Corporation
Goldman Sachs
Graham, Benjamin
 and Dodd, placed in context

financial accounting, uses and limitations of

going concern and investment company views of businesses

market performance, importance of

market risk vs. investment risk and margin of safety

modern capital theory vs.

OPMI defined

OPMI perspective of analysis

primacy of income account and appraisal of managements

primacy of income account and diversification

primacy of income account, dividends, and corporate uses of cash

primacy of income account and growth stocks

primacy of income account and top-down vs. bottom-up analysis

primacy of income account and wealth creation

promoters, compensation of

stock market prices

substantive consolidation

trade-offs

view on NAV

Great American Holding Company

The Great Risk Shift (Hacker)

Greentown China Holdings

Gross spreads, underwriting

Growth at dirt cheap prices (GADCP)

Growth at a reasonable price (GARP)

H

Hang Lung Properties

Hart-Scott-Rodino filings

Hayek, F. A.

Heller Financial

Henderson Land Development

Hertz Global Holdings

cash payments to sponsors and controlled investment funds

common stock price

consolidated cash flows

- EBITDA
- leveraged buyout of
- income statement
- Hess Oil and Chemical
- Hewlett-Packard Company
- Home Depot, Inc.
- Home Insurance Company
- Hopewell Holdings

I

- IBM. *See* International Business Machines Corporation
- IFRS. *See* International Financial Reporting Standards
- Income account, primacy of
 - common stock prices, influence of reported earnings on
 - long-term earnings record
 - parsing
 - wealth creation
- Instinet Group
- Intel Corporation
- The Intelligent Investor* (Graham)
- International Business Machines Corporation (IBM)
- International Financial Reporting Standards (IFRS)
- Investing vs. speculating
 - definitions
 - for income or total return
 - method of purchase and holding time horizon
 - operation rather than issue
 - safety of principal as avoidance of risk
 - type of security
- Investment Advisers Act of 1940
- Investment Company Act of 1940
- Investment risk
 - avoidance of

methods

- components of
- minimizing
- specific

Investor A/B

J

- Johnson & Johnson
- JPMorgan Chase & Co.

K

- Kelly formula

Key Corp.
Keynes, John Maynard
Kmart
Kraft Foods Inc.
Krugman, Paul

L

Lai Sun Garment
Lazard Freres
Leasco Data Processing Company
 institutional investors and subscription percentages
Lehman Brothers
Leveraged buyouts, private equity
 acquisition of Hertz Global Holdings
 capital markets, super-attractive access to
 cash payments to sponsors and sponsor-controlled funds
 questions about
 sponsors attuned to needs of bankers and underwriting community
 sponsors' control of Hertz
Liquidation

M

MacArthur, Alfred
Managements, appraisal of
 GARP vs. GADCP
 growth at dirt cheap prices (GADCP)
 growth at a reasonable price (GARP)
 new framework for
 OPMI interests, managements attuned to
 as resource converters
Marginalism
Market efficiency
 determinants of
 complexity
 external forces
 market participant
 time horizons
external disciplines, lack of
 corporate monopolies and oligopolies
 hedge-fund operators
 investment bankers
 merchant bankers

money management
other professionals
promoters in trading environments
securities salespeople
top corporate managements

external forces influencing
and fair prices in takeovers
value investors, learning from

Market performance, significance of
bailouts
and character of a portfolio
outsiders, insiders, and market price
of portfolios vs. individual securities
professional money managers and beating the market

McDonald's Corp.

MCT. *See* Modern capital theory

Merck & Co. Inc.

Merger and acquisition activity

Merrill Lynch

Microsoft

Modern capital theory (MCT)

analyzing companies as going concerns and investors in marketable securities as investment companies
creditor control
discounted cash flows, value determined by forecasts of
diversification, as protection against unsystematic risk
equilibrium pricing
free markets
general laws
vs. Graham and Dodd
macro considerations
market efficiency
market risk
OPMI market
OPMIs, relevance of
point of view
risk-adjusted total return as goal
systematic risk
transaction costs

Morgan Stanley

Myths, debunking

N

Nabors Industries

NASDAQ

Net asset value (NAV)

annual per share, growth rate, per share market price, and premium (discount) to
common stocks, recommended
companies selling at discounts from
static and dynamic views
authors' view on

dynamics, importance of
financial accounting view on
Graham and Dodd view on
growing, OPMI investing in companies with
limitations of, in security analysis
net nets redefined
potential liquidity, NAV as measure of
relationship of price to reported 10-year earnings and
(2012)
resources, NAV as measure of
ROE and PE ratios, relationship between
in security analysis, usefulness of

Net nets

Net present value (NPV)

The New Industrial State (Galbraith)

New York Stock Exchange (NYSE)

Nokia Siemens

NPV. *See* Net present value

NYSE. *See* New York Stock Exchange

O

Other people's money (OPM)

Outside passive minority investors (OPMIs)
defined

perspective of analysis
and their representatives, needs and desires of

P

Penn Central

Pfizer Inc.

Philip Morris

PITA investing

Plan of reorganization (POR)

Pressprich, R. W., and Company

Price to book value ratio, SPX index (historical)

Principles of Corporate Finance (Brealey & Myers)
Procter & Gamble Co.
Public Service Company of New Hampshire
Pure going concern view

Q

Quality of assets

R

Rating agencies, needs and desires of
Real estate investment trusts (REITs)
Refco
Reliance Insurance Company
Reorganizations
 bankruptcy, prepackaged or preplanned
 Chapter 11 filing, conventional
 role of government in
 bailouts or capital infusions
 corporate reorganizations and liquidations, revolution in
 failure of financial institutions
 financial institutions, strict regulation of
 moral hazards
 partnership between government and private sector
 taxpayer bailouts
 voluntary exchanges
Residential Capital LLC
Resource conversion
 activities of Dow Jones Industrial companies (2007–2012)
 capitalization in
 corporate contests for control
 1970s through 2012
 shark repellent, emergence of
 existing assets, more aggressive employment of
 going private and leveraged buyouts
 example
 tax shelter, other people's money, and something off the
 top
 merger and acquisition activity
 OPMI prices and control values, long-term arbitrage between
Restructuring troubled companies
 five basic truths of distress investing

rehabilitation

capital infusions

reorganizations

Section 363 sales

Retained earnings

financing with

Return on equity (ROE) analysis

and PE ratios, relationship between

Return on investment (ROI) analysis

Revlon rules

Riskless arbitrage

The Road to Serfdom (Hayek)

ROE. *See* Return on equity analysis

ROI. *See* Return on investment analysis

S

Safe and cheap investing

approach

benefits for OPMI

availability of multiple exits

confidence in investment commitments

investment-risk-resistant commitments

restrictions and demands of

activists and

avoidance of predatory control groups

dismissal of conventional wisdom

and know-who

missing of attractive opportunities

motivating factors, understanding

restricting investment universe

Sarbanes-Oxley

Schaefer, F. & M., Corporation

consideration given to sellers of capital stock

family ownership interests

purchasers of 170,000 corporation common

sources of funds and securities in transaction

spread between what corporation and others get, composition of

transformation to different discipline

Schenley Industries

SEC. *See* Securities and Exchange Commission

Securities

buying in bulk

acquisition of control by using proxy machinery
common stocks, methods for acquisition of
voting equities, acquisition of through exchanges of
securities

substantive characteristics of

classification

control vs. non-control

as options, terms of

pricing and arbitrage, control and non-control

types of, for analytic purposes

types of

Securities Act of 1933

Securities Exchange Act of 1934

Securities and Exchange Commission (SEC)

Securities Investors Protection Act of 1970

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Shareholder distributions, from the company point of view

cash dividends or retained earnings

distribution of assets other than cash

liquidation

stock dividends

stock repurchases

Sharpe, William F.

Short-termism, primacy of

Smith, Adam

Society Corporation

Solvency, tests of

Something off the top (SOTT)

Source Capital Preferred

SOX. *See* Sarbanes-Oxley

Sponsorship

Stock dividends

Stock repurchases

Structural subordination

Substantive consolidation

doctrine, accounting for stock options controversy in light of

failure to use

Surplus surplus

T

Tax shelter (TS)

The Theory of Investment Value (Williams)

Third Avenue Value Fund
3M
Tishman Realty
Top-down analysis, primacy of
Toyota Industries Corporation
 balance sheet for
Travelers Companies, Inc.
Treasury notes
Troubled Asset Relief Program (TARP)
Trust Indenture Act of 1939
TS. *See* Tax shelter

U

United Technologies Corp.
U.S. securities laws and regulations
U.S. Treasury Notes

V

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Value investing
Value Investing: From Graham to Buffett and Beyond (Greenwald, Kahn, Sonkin, & Van Biema)
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Verizon Communications Inc.
Voting equities, acquisition of through exchanges of securities
 mandatory
 voluntary

W

Wal-Mart Stores Inc.
Walt Disney Co.
Wealth creation
 long-term
 methods of
Wharf Holdings
 annual per share NAV, growth rate, per share market price and premium (discount) to NAV
Wheelock and Company
White Mountains Insurance Group
White, Weld and Company
Williams, John Burr
Wilmington Trust
WorldCom

X

Xerox

Z

“Zombie Banks”